Supreme Court, U.S.
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No. 04- 04-599

IN THE

Supreme Court of the United States

JAY HENDRICKSON, ROSE HENDRICKSON and KATHLEEN O'BRIEN, on behalf of themselves and all others similarly situated,

Petitioners,

v.

AMERICAN SKANDIA LIFE ASSURANCE CORPORATION, AMERICAN SKANDIA MARKETING, INCORPORATED, AMERICAN SKANDIA INVESTMENT HOLDING CORPORATION, ABC CORP., INC. 1 through ABC CORP., INC. 99, and LMN CORP., INC. 1 through LMN CORP., INC. 99,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

The Second Circuit affirmed the district court's Federal Rule 12(b)(6) dismissal of Petitioners' complaint for violations of the federal securities laws, ruling as a matter of law that all material information was sufficiently disclosed in the prospectuses at issue. In making its determination, the Second Circuit completely disregarded (as the district court also had done) specific rules of the National Association of Securities Dealers ("NASD") as well as the specifically stated position of the Securities Exchange Commission ("SEC") — the entities entrusted by Congress to interpret and enforce the federal securities laws. The Second Circuit's ruling raises a question never addressed by the Supreme Court regarding whether the NASD — a self-regulatory organization ("SRO") acting under the strict supervision of the SEC, which issues and enforces rules pursuant to the approval of the SEC, and which enjoys the same immunity from civil suits as the SEC — is deserving of similar or the same judicial deference as the SEC receives. In addition, by ignoring the SEC's position, a question is raised as to whether the Second Circuit's ruling conflicts with the Supreme Court's precedents regarding the proper judicial deference owed to an executive administrative agency such as the SEC. Finally, by ignoring the rules and positions of the NASD and the SEC, a question is raised as to whether the Second Circuit's ruling conflicts with the Supreme Court's precedents concerning the proper scope of a court's discretion in determining whether disclosure obligations have been met as a matter of law in a case brought under the federal securities laws.

Three questions are therefore presented:

I. Are the consistently held positions and rules of the NASD — which acts under the strict supervision of the SEC and whose rules the SEC strictly controls — entitled to judicial deference under any of the standards previously set forth by this Court, or under some other standard, particularly where the NASD has specific expertise and experience regarding the precise question at issue?

II. Did the Second Circuit contravene the Supreme Court's precedents concerning the proper judicial deference to be given to executive administrative agencies, when it disregarded the clearly stated position of the SEC and made the determination as a matter of law that Respondents had met their disclosure obligations under the Securities Act of 1933 and the Securities Exchange Act of 1934?

III. Did the Second Circuit contravene the Supreme Court's precedents, requiring that all inferences be drawn in favor of the pleader on a Fed. R. Civ. P. 12(b)(6) motion and directing courts to leave questions of materiality to the trier of fact unless it is clear that the alleged omissions and misleading statements would be of no significance to investors, when it ignored the clearly stated rules and expertise of the SEC and NASD in its determination that all material disclosures were made as a matter of law in an action brought under the Securities Act of 1933 and the Securities Exchange Act of 1934?

LIST OF PARTIES

Petitioners are Jay Hendrickson, Rose Hendrickson and Kathleen O'Brien.

American Skandia Life Assurance Corporation, American Skandia Marketing, Incorporated and American Skandia Investment Holding Corporation are being served as Respondents.

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OPINIONS BELOW

The opinion of the Second Circuit Court of Appeals affirming the district court dismissal, entered on May 14, 2004, is unpublished and is included as Appendix A hereto.

The district court's July 31, 2003 memorandum opinion and order dismissing the action is unpublished and is included as Appendix B hereto.

The district court's September 2, 2003 memorandum opinion and order denying Petitioners' motion to alter the judgment and amend the complaint is unpublished and is included as Appendix C hereto.

STATEMENT OF JURISDICTION

Jurisdiction in the Supreme Court is invoked under 28 U.S.C. § 1254(1).

The opinion of the Second Circuit Court of Appeals, which is the judgment sought to be reviewed, was entered on May 14, 2004. (Appendix A). The Second Circuit denied Petitioners' timely-filed Petition for Rehearing on July 30, 2004. (Appendix D).

STATUTES, RULE AND REGULATION INVOLVED

The underlying litigation involved alleged violations of the federal securities laws and the regulations promulgated thereunder by the Securities Exchange Commission, as well as the Federal Rules of Civil Procedure, as follows:

Title 15 United States Code, Section 78j

§ 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not

so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Title 15 United States Code, Section 77l

§ 77l. Civil liabilities arising in connection with prospectuses and communications

(a) In general. Any person who—

(1) offers or sells a security in violation of section 5, or

(2) offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraphs (2) and (14) of subsection (a) thereof), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable, subject to subsection (b), to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less

the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Federal Rules of Civil Procedure - Rule 12

Rule 12. Defenses and Objections—When and How Presented—By Pleading or Motion—Motion for Judgment on the Pleadings

* * *

(b) How Presented. Every defense, in law or fact, to a claim for relief in any pleading, whether a claim, counterclaim, cross-claim, or third-party claim, shall be asserted in the responsive pleading thereto if one is required, except that the following defenses may at the option of the pleader be made by motion: (1) lack of jurisdiction over the subject matter, (2) lack of jurisdiction over the person, (3) improper venue, (4) insufficiency of process, (5) insufficiency of service of process, (6) failure to state a claim upon which relief can be granted, (7) failure to join a party under Rule 19. . .

17 C.F.R. § 240.10b-5 (1995)

[*see infra* at pages 25-26]

STATEMENT OF THE CASE

The Parties

Respondent American Skandia Life Assurance Corporation ("American Skandia") is one of the largest insurance and variable annuity companies in the United States and the world. It markets its products to broker-dealers and financial planners through an internal field marketing staff and in conjunction with financial institutions such as banks. Respondent American Skandia Marketing, Incorporated ("ASM"), a registered broker-dealer and a member of the NASD, is American Skandia's principal underwriter and the principal distributor of American Skandia's variable annuity products. Respondent American

Skandia Holding Company "(ASIHC") is the ultimate parent of American Skandia and ASM.

Petitioners purchased, for their respective Individual Retirement Accounts ("IRA"), variable annuity products issued, underwritten and/or marketed by Respondents. Petitioners purchased those variable annuity products pursuant to Respondents' registration statements, written prospectus and statements of additional information ("SOAI"). Petitioners allege that Respondents aimed their sales at financially unsophisticated individuals and small business owners for use in their qualified tax-deferred retirement plans such as IRAs, Keoghs and 401(k)s, viewing as prime prospects investors who where leaving their employment and needed a rollover IRA in which to place the proceeds of their employers' qualified retirement plans while preserving their tax-deferred status.

Nature of Petitioners' Case

As further discussed below, sales of variable annuity products have dramatically increased to over $126 billion in the United States, with nearly 60% of the total sales last year placed into IRAs and employee-sponsored retirement plans. There was no dispute below that these tax-deferred variable annuity products, when placed in a contributory retirement account, provide no additional tax benefits than are already provided by "qualified" accounts under the Internal Revenue Code — and, therefore, there is no reason whatsoever to purchase these variable annunities for tax deferral purposes. (Qualified plans and accounts include many of the most popular and common plans for retirement investing: IRAs, Keoghs, 401(k) plans and other accounts treated similarly by the tax code.) Because variable annuity products carry with them extremely high fees and charges (on top of the charges of a qualified retirement account) which over time can deprive purchasers of up to *one-third* of their total account value, an investor who purchases variable annuities for tax-deferral purposes is simply wasting a significant sum of money. In fact,

the SEC and the NASD, as discussed below, have both made clear that variable annunities should only be purchased for qualified plans if their other features (principally "insurance" features) have a real value to the investor. And, the circumstances under which the "insurance" features have any value to an investor are extremely rare. Those circumstances are (i) when the variable annuity owner chooses to exercise the annuity payout option at the end of the investment period, which occurs, on average, only 1% of the time; and (2) when the variable annuity owner makes use of a "death" benefit, but that benefit assumes two unlikely events: extremely premature death of the investor and that the market value of the annuity at the time of death is less than the amount the investor paid.[1]

The gravamen of Petitioners' case is that the prospectuses and SOAIs pursuant to which they purchased their variable annuities did not disclose the fact that an investor with a tax-deferred retirement account would obtain *no additional tax benefit whatsoever* from purchasing a variable annuity for his or her already tax-deferred account. Indeed, the prospectuses at issue actually contained statements suggesting that tax-deferred variable annuity products *were* appropriate investments for placement into already tax-deferred retirement accounts. For example, on the very front page of their prospectuses, after the question "WHY WOULD I CHOOSE TO PURCHASE THIS ANNUITY?," the prospectus states: "This annuity is frequently

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1. A recent article in the *Wall Street Journal* emphasized that the benefits from the "insurance" features of a variable annuity investment are extremely rare. *See* Jonathan Clements, *A 'Conservative' Investment That Comes at Too High a Price: Variable Annuities*, Wall Street Journal, Jan. 21, 2004 (noting the steep costs of variable annuities and citing a study in the March 2001 *Journal of Risk and Insurance* which calculated that the insurance features of a variable annuity investment are worth less than 0.01% a year for the average 30-year old investor, and still only 0.63% a year for the average 65-year old investor — far less than the 1.18% per year mortality charge on such investment). (It should also be noted that for a 65-year old, the statutory requirement that withdrawals must start at age 70 makes the deferred tax feature of little value.)

used for retirement planning. *It may be used as an investment vehicle* for an IRA, a SEP-IRA, ROTH IRA, or Tax Sheltered Annuity (or 403b). It may also be used for other purposes that are not qualified investments." As another example, after the paragraph heading "What Tax Considerations Are There For Tax Qualified Retirement Plans or Retirement Contracts," the prospectus states: "An annuity may be suitable as a funding vehicle for various types of tax-qualified retirement plans . . ." As another example, after the paragraph heading "Uses Of The Annuity," the prospectus states: "The Annuity may be issued in connection with or purchased as a funding vehicle for certain retirement plans designed to meet the requirements of various sections of the Code [listing code sections including 401(k), tax-sheltered annuities, and IRAs] . . . ."

Petitioners alleged that the misstatements and omissions in the prospectuses and SOAIs violated Sections 10(b) and 20 of the Securities Exchange Act of 1934 (the "Exchange Act"), as amended, 15 U.S.C. §§ 78j(b) and 78t(a), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5; and Sections 11 and 15 of the Securities Act of 1933 (the "Securities Act"), 15 U.S.C. §§ 77(k), 77(l) and 77(o).

Because variable annuities are virtually never suitable investments for qualified retirement plans, and because investors gain absolutely no additional tax benefit from a variable annuity investment in a qualified retirement plan while paying substantial additional fees, the NASD has *mandated* across-the-board disclosure requirements on this very subject. The NASD mandates that its members (which include annuity underwriters such as Respondent ASM) tell potential purchasers that the tax deferred feature of a variable annuity is already provided by a qualified retirement plan and that such investments should *only* be made if the other benefits of the annuities, such as the death benefit, support the purchase. Specifically, NASD Notice to Members 99-35, which was issued in May 1999 and applies directly to wholesalers and retailers of variable annuities, "reminded" members to disclose to the customer that "the tax

deferred accrual feature is provided by the tax-qualified retirement plan and that the tax deferred accrual feature of the variable annuity is unnecessary." (Appendix E at 25a ¶ 11, NASD Notice to Members 99-35.) The NASD has taken this mandate extremely seriously and has followed through with enforcement actions against members resulting in major censures and fines. *See infra*.[2]

The SEC has also specifically recognized continuing problems in the sale of variable annuities to tax-qualified accounts, and has issued a Joint Report with the NASD on the precise issue addressed by the NASD in its Notice to Members 99-35. The Joint Report, dated June 9, 2004 and entitled "Joint SEC/NASD Report on Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products," followed an extensive examination of the practices of broker-dealers that sell variable annuities. *See* Office of Compliance Inspections and Examinations, United States Securities and Exchange Commission/NASD, "Joint SEC/NASD Report on Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products" (June 2004) (available at http://www.sec.gov/news/studies/secnasdvip.pdf). In the Joint Report, the SEC and NASD stated that written disclosures should be included in the prospectus (and/or the accompanying documents) which, among other items, highlight the federal tax treatment of the annuity. The SEC and NASD concluded that the failure to disclose the "lack of additional tax benefit when purchasing an annuity in a" tax-qualified account is a "weak practice" which "*may constitute a violation of the general antifraud provisions of the federal securities laws*." *Id.* at 17-18, 19.[3]

2. On or about October 23, 2000, in an implicit admission that their prospectuses did not comply with this NASD concern, Respondents finally changed the wording in their prospectuses to read: "Purchasing an annuity as an investment vehicle for a "qualified" investment does not provide any additional tax advantages to that already available through your retirement plan under the Internal Revenue Code."

3. The SEC has taken this issue extremely seriously over the last (Cont'd)

Despite the fact that the rules and positions of the SEC and NASD were directly on point, the Second Circuit did not consider those rules and positions in connection with its determination that all material information was disclosed to Petitioners as a matter of law.[4]

(Cont'd)
several years, and has consistently agreed with the NASD that the type of mandate found in NASD Notice to Members 99-35 needs to be followed. *See, e.g.*, Paul F. Roye, Director, Division of Investment Management, SEC, Variable Products: Industry Success, Industry Responsibilities, Speech at the Nat'l Ass'n For Variable Annuities Regulatory Affairs Conference (June 28, 1999), *reprinted at http://www.sec.gov/news/speech/speecharchive/1999/spch285.htm* (stating that the NASD's reminder in 99-35 about the disclosures required in sales of variable annuities for qualified plans is "right on target"); United States Securities and Exchange Commission, *Variable Annuities: What You Should Know . . .*, at 3 (August 2000) (available at *http://www.sec.gov/pdf/varannty.pdf*):

> [I]f you are investing in a variable annuity through a tax-advantaged retirement plan (such as a 401(k) plan or IRA), you will get **no additional tax advantage** from the variable annuity. Under these circumstances, consider buying a variable annuity only if it makes sense because of the annuity's other features, such as lifetime income payments and death benefit protection.

(emphasis in original); SEC Roundtable on Investment Adviser Regulatory Issues, May 23, 2000 (available at *http://www.sec.gov/divisions/investment/roundtable/iadvrndt.htm*) (discussing how putting a variable annuity into a tax-advantaged plan "is an area that is particularly harmful" to investors and that it is hard to "even imagine a justification" for it).

4. The Second Circuit did touch upon the NASD's and SEC's rules and positions, but *only* in deciding that Respondents had no "duty" to disclose. (Appendix A at 4.) However, Petitioners did not introduce those rules and positions to show a duty. Rather, the duty to disclose is based on the statutory duty, found in Section 11 of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 promulgated under the Exchange Act, to disclose any material facts that are necessary to

(Cont'd)

Procedural Background

Petitioners filed their complaint in the Southern District of New York on December 13, 2002, which was later amended on April 16, 2003.[5] On May 16, 2003, Respondents filed their Motion to Dismiss under Rule 12(b)(6) of the Federal Rules of

(Cont'd)
make disclosed material statements not misleading. *See* 15 U.S.C. §§ 77k, 77l, 78j. *See In re Time Warner Sec. Litig.*, 9 F.3d 259, 268 (2d Cir. 1993) ("a duty to disclose arises when disclosure is necessary to make prior statements not misleading."); *Shaw v. DEC*, 82 F.3d 1194, 1202 n.3 (1st Cir. 1996); *Kushner v. Beverly Enters., Inc.*, 317 F.3d 820, 831 (8th Cir. 2003). The Second Circuit further suggested that it was not necessary to consider NASD and SEC rules in determining whether disclosure obligations were met because the prospectuses somehow sufficiently disclosed the allegedly omitted information. (Appendix A at 5a-6a).However, a reading of the pages of the prospectus referred to by the Second Circuit clearly shows that the information mandated and urged by the NASD and SEC but ignored by the Second Circuit (that "the tax deferred accrual feature is provided by the tax-qualified retirement plan and that the tax deferred accrual feature of the variable annuity is unnecessary") is not even remotely present. The Second Circuit nonetheless found that a statement in the prospectus that investment gains on annuities are not taxable "until an amount is received (a 'distribution')" (Appendix F at 34a, Prospectus at 39), combined with a statement three pages later that contributions to qualified retirement plans are "not taxable until distributions are made" (Appendix F at 42a, Prospectus at 42), would lead a reasonable investor to a conclusion that funding a retirement plan with deferred annuities "would provide no additional tax advantage." (Appendix A at 6a.)

5. Petitioners brought their action as a class action pursuant to Federal Rules of Civil Procedure 23(a) and 23(b)(3), on behalf of themselves and all persons who, beginning on December 13, 1997, purchased an individual tax-deferred annuity contract or who received a certificate to a group tax-deferred annuity contract, issued, underwritten, marketed or sold by any or all of the defendants, which was used to fund a contributory (not defined benefit) retirement plan or arrangement qualified for favorable income tax treatment pursuant to Internal Revenue Code sections 401(a), 401(k), 403(a), 403(b), 408(a), 408(b), 408(k), 408(p), 408A, or 457 (the "Class Period").

Civil Procedure. Notwithstanding the overtly deceptive statements and omissions, which ran directly contrary to specific NASD disclosure rules, the district court dismissed the case by Order dated July 31, 2003 and entered Judgment on August 4, 2003. On August 14, 2003, Petitioners filed a motion to alter the August 4, 2003 Judgment and allow a further amended complaint, which the district court denied by Order dated September 2, 2003.

Petitioners filed their Notice of Appeal from the September 2, 2003 Order on September 30, 2003. By Summary Order entered May 14, 2004, a Panel of the Second Circuit Court of Appeals affirmed the district court's dismissal of the case. Consistent with the district court's approach, the Second Circuit specifically declined to consider the NASD's or the SEC's position on the significance of the omitted information to investors. Petitioners timely filed their Petition For Rehearing or Rehearing *En Banc* which the Second Circuit denied without opinion on July 30, 2004.

REASONS FOR GRANTING THE PETITION

Supreme Court Rule 10(c) recognizes that the Supreme Court should consider granting certiorari when a United States court of appeals has decided an important question of federal law which has not been, but should be, settled by the Supreme Court. Here, the issue of whether a federal court should give deference to the NASD, particularly in determining the scope of disclosure obligations under the federal securities laws on a motion to dismiss, has not been but should be settled by the Supreme Court.

Supreme Court Rule 10(c) also recognizes that the Supreme Court should consider granting certiorari when a United States Court of Appeal has decided an important federal question in a way that conflicts with relevant decisions of the Supreme Court. Here, the Second Circuit has also made a determination, on a motion brought under Fed. R. Civ. P. 12(b)(6), that directly conflicts with the relevant precedents of this Court. The Second Circuit's disregard for the SEC position on disclosure obligations

in connection with variable annuities, as reflected in the Joint Report and other SEC pronouncements, is in conflict with the Supreme Court's consistent body of law requiring that proper judicial deference be given to executive administrative agencies.

In addition, by wholly disregarding both the SEC and NASD with regard to the significance of certain specified disclosures to investors, the Second Circuit's decision is at odds with the Supreme Court's precedents permitting a court to decide the materiality issue as a matter of law only in the rare circumstance where the allegedly omitted information would clearly not be of significance to investors. Here, the Second Circuit was faced with exactly the opposite sort of rare circumstance: It had clear guidance before it, from the SEC and NASD, demonstrating that the information at issue *would be of significance* to a reasonable investor. Yet, the Second Circuit chose to completely disregard that guidance and adopt its own view instead.

Whether it was proper for the Second Circuit to disregard NASD and SEC rules and positions, and whether it was proper for the Second Circuit to determine that all material information was disclosed in Respondents' prospectuses even though the information mandated by the NASD of its members and urged by the SEC was not disclosed, are important questions for which this Court's guidance is urgently warranted. These questions need to be addressed immediately because sales of variable annuity products in the United States are dramatically increasing each year, and those sales continue to target tax-qualified retirement plans. Indeed, it has been reported that the sale of variable annuities has increased from $25 billion in 1992 to over $126 billion in 2003, with nearly 60% of the total variable-annuity sales last year placed into individual retirement accounts and employer-sponsored plans. Those figures are expected to grow as retiring baby boomers look for a place to park their savings.[6] This Court's guidance is needed in order to determine

6. *See* Kathy Chu, *Variable Annuities; A Bad 'Wrap'*, Wall St. J., Oct. 4, 2004 (citing a report of the National Association of Variable Annuities in Reston, VA).

what significance, if any, a court should give to the positions of the SEC and NASD on this matter in a case brought under the federal securities laws. As it stands, it is wholly unclear what type of deference a court owes to the NASD, or what type of consideration a court must give to SEC and/or NASD rules and positions in connection with a materiality analysis on a motion to dismiss.

Moreover, the Second Circuit's complete disregard for SEC's and NASD's rules and positions threatens to fundamentally undermine the strength of those rules and positions in the SEC's and NASD's own enforcement proceedings. NASD members, as well as issuers of variable annuities, may now use the Second Circuit's ruling to argue that they have no obligation to disclose information urged and/or required by the SEC and NASD.

The questions presented on this Petition are of even greater importance because Petitioners have been driven into the federal system only to be then told by the Second Circuit that they have no claim under federal law. Prior to 1998, the state court systems of the 50 states would clearly have had concurrent jurisdiction over this action, since variable annuities are both an insurance product and a "security" as defined by federal law. The claims asserted in this case would likely have previously been sustainable on a motion to dismiss in a state court under state law, and Petitioners would at the very least have had an opportunity to prove their case in a state court proceeding. However, as a result of the enactment by Congress in 1998 of the Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227, codified at 15 U.S.C. § 77, *et seq.* ("SLUSA"), all class actions related to the purchase of securities may now only be brought in federal court under federal law, even though the variable annuity "securities" at issue have substantial non-securities aspects. *See Lander v. Hartford Life & Annuity Ins. Co.*, 251 F.3d 101 (2d Cir. 2001) (confirming that SLUSA pre-empted state court actions alleging fraud or misrepresentation under state law, including consumer

protection statutes, and finding that such claims must be brought only under the federal securities laws.)

The importance of certiorari to consider the facts of this case is further underscored by the Supreme Court's consistent admonition that *full disclosure* is the policy chosen and expressed by Congress in relation to the federal securities laws. As the Court stated in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), in connection with the proper application and interpretation of the federal securities laws:

> Disclosure, and not paternalistic withholding of accurate information, is the policy chosen and expressed by Congress. We have recognized time and again, a "fundamental purpose" of the various securities acts, "was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry."

Id. at 234 (quoting *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963)). This Petition presents the Court with an opportunity to reaffirm the proper scope of disclosure obligations under the federal securities laws, and particularly the role of the court in determining whether those disclosure obligations have been met as a matter of law.

Petitioners also respectfully note that apparently every federal court that has addressed the precise question presented in this case, *i.e.* whether the omission of the NASD-mandated disclosure may be actionable under the federal securities laws, has ruled directly contrary to the Second Circuit. Petitioners are aware of three such rulings, all at the district court level. *See Johnson v. Aegon USA, Inc.*, C.A. No. 1:01-CV-2617-CAP, 2004 U.S. Dist. LEXIS 20471 (N.D. Ga. Sept. 20, 2004) (specifically rejecting the Second Circuit's view in this case and recognizing the relevance of NASD disclosure rules, including NASD Notice to Members 99-35, to determine potential materiality of an omission on a motion to dismiss with respect to claims under Section 11 and 12(a)(2) of the Securities

Act of 1933); *Nelson v. Pacific Life Ins. Co.*, No. Civ. A. CV 203-131, 2004 WL 1592617, at *3 (S.D. Ga. July 12, 2004) (denying motion to dismiss while addressing the relevance of NASD Notice to Members 99-35 with respect to claims under the Securities Exchange Act of 1934); *Drnek v. Variable Annuity Life Ins. Co.*, No. CIV 01-242-TUC-WDB, 2004 U.S. Dist. LEXIS 9490 (D. Ariz. May 3, 2004) (denying summary judgment motion and citing NASD Notice 99-35 with respect to claims brought under Securities Exchange Act). While no appellate court other than the Second Circuit has addressed the issue, the Second Circuit's ruling in this case has created confusion as to the relevance of the positions of the NASD and/or SEC in a disclosure analysis under the federal securities laws. That confusion should now be resolved by the Supreme Court.

I. Review Is Warranted To Determine Whether Judicial Deference Should Be Given To The Rules And Decisions Of The NASD

Whether deference is owed to the NASD, and if so under what circumstances and of what type, is clearly a question of first impression. The question is of particular importance on this motion to dismiss under Federal Rule 12(b)(6), where the Court has dismissed the case based on its view that an omission would be unimportant to a reasonable investor while ignoring the clearly stated opposite position of the NASD.

A. The Supreme Court Has Directed That Judicial Deference Be Given To Administrative Agencies Under Various Standards

Over the last 30 years, the Supreme Court has consistently recognized that significant judicial deference is owed to an executive administrative agency that has expertise on a question at issue in a case. In *Chevron USA Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), the Court issued its seminal decision regarding the need for, and the basis of, judicial deference to administrative agencies. Two recent decisions by the Court — *United States v. Mead Corp.*, 533 U.S. 218 (2001) and *Christensen v. Harris County*, 529 U.S. 576 (2000) —

further elaborated upon when such deference should be given and the extent of the deference that should be given. In *Mead*, 533 U.S. at 227-28, the Court reviewed the range of deference directed by the Court in its various past decisions on the subject:

> "The well-reasoned views of the agencies implementing a statute 'constitute a body of experience and informed judgment to which courts and litigants may properly resort for guidance,'" *Bragdon v. Abbott*, 524 U.S. 624, 642, 141 L. Ed. 2d 540, 118 S. Ct. 2196 (1998) (quoting *Skidmore*, 323 U.S. at 139-40), and "we have long recognized that considerable weight should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer . . ." *Chevron*, *supra*, at 844 (footnote omitted); *see also Ford Motor Credit Co. v. Milhollin*, 444 U.S. 555, 565, 63 L. Ed. 2d 22, 100 S. Ct. 790 (1980); *Zenith Radio Corp. v. United States*, 437 U.S. 443, 450, 57 L. Ed. 2d 337, 98 S. Ct. 2441 (1978). The fair measure of deference to an agency administering its own statute has been understood to vary with circumstances, and courts have looked to the degree of the agency's care, its consistency, formality, and relative expertness, and to the persuasiveness of the agency's position, *see Skidmore*, *supra*, at 139-140. The approach has produced a spectrum of judicial responses, from great respect at one end, *see, e.g.*, *Aluminum Co. of America v. Central Lincoln Peoples' Util. Dist.*, 467 U.S. 380, 389-390, 81 L. Ed. 2d 301, 104 S. Ct. 2472 (1984) ("'substantial deference'" to administrative construction), to near indifference at the other, *see, e.g.*, *Bowen v. Georgetown Univ. Hospital*, 488 U.S. 204, 212-213, 102 L. Ed. 2d 493, 109 S. Ct. 468 (1988)

> (interpretation advanced for the first time in a litigation brief).

Id. (footnotes omitted).

The *Mead* Court concluded that administrative interpretations are to receive actual judicial deference, sometimes referred to as "*Chevron* deference," when it appears that Congress has "delegated authority to the agency generally to make rules carrying the force of law." *Mead*, 533 U.S. at 226-27.[7] The *Mead* Court also stated that even where Congress has not delegated rulemaking authority to an agency, the agency's interpretations are still entitled to judicial deference of the sort mandated by the Court in a 1944 decision of the Court in *Skidmore v. Swift & Co.*, 323 U.S. 134, 139-40 (1944). As quoted

7. One commentator has strongly argued that whether or not it has been specifically delegated rule making authority, an agency with expertise should be the preferred decisionmaker in an area in which it has expertise and which the Court does not. *See* Russell L. Weaver, *Deference to Regulatory Interpretations: Inter-Agency Conflicts*, 43 Ala. L. Rev. 35, 36 (1991) (noting deference rule requires federal courts to defer to an administrative in its interpretation of agency's governing statute). *See also* Russell L. Weaver, *The Empower Has No Clothes: Christensen, Mead and dual Deference Standards*, 54 Admin. L. Rev. 173 (2002). *See also United States v. Haggar Apparel Co.*, 526 U.S. 380, 392 (1999) (where regulations of Customs Service were at issue, the Court remanded the case for a determination of whether the regulations ultimately warranted deference where the appellate court and lower court had declined to analyze the regulation); *NationsBank of N.C., N.A. v. Variable Annuity Life Ins. Co.*, 513 U.S. 251, 257 (1995) (if an agency's statutory interpretation "fills a gap or defines a term in a way that is reasonable in light of the legislature's revealed design, we give [that] judgment 'controlling weight.'") (citations omitted); *Chem. Mfrs. Ass'n v. Natural Res. Def. Council, Inc.*, 470 U.S. 116, 125 (1985) (the complexity of a statutory scheme often leaves a court with no option but to defer to the expertise and interpretation of an administrative agency); *FCC v. Nat'l Citizens Comm. for Broad.*, 436 U.S. 775, 814 (1978) (ruling that "a forecast of the direction in which future public interest lies necessarily involves deductions based on the expert knowledge of the agency") (citations omitted).

by the *Mead* Court, the *Skidmore* Court described the alternative type of judicial deference that a court should give to an agency when its interpretation lacks "the power to control":

> We consider that the rulings, interpretations and opinions of the Administrator. . . , while not controlling upon the courts by reason of their authority, do constitute a body of experience and informed judgment to which courts and litigants may properly resort for guidance. The weight of such a judgment in a particular case will depend upon the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control.

Id. at 140. Thus, while *Skidmore* deference does not require courts to absolutely defer to an agency's interpretation, it allows a court to give that interpretation the weight that it deserves based on its relative "persuasiveness." *See Mead*, 533 U.S. at 227.

In *Christensen*, 529 U.S. at 587, decided a year prior to *Mead*, the Court focused on the form in which an administrative agency position appears. The Court held that while agency interpretations "contained in policy statements, agency manuals, and enforcement guidelines, all of which lack the force of law — do not warrant *Chevron*-style deference," they would be still entitled to *Skidmore* deference. The *Christensen* Court, however, did not foreclose the application of *Chevron* deference to agency positions set forth in formats other than formal adjudications or rulemaking. Indeed, several decisions of the Court since *Chevron* indicate that the form in which an agency position appears is not as significant as whether Congress delegated to the agency the authority to make rules carrying the force of law. *See Auer v. Robbins*, 519 U.S. 452, 462 (1997) (that the Secretary of Labor's interpretation of a regulation comes in the form of a legal brief "does not, in the circumstances of this case, make it

unworthy of deference. The Secretary's position is in no sense a '*post hoc* rationalization' advanced by an agency seeking to defend past agency action against attack.") (citing *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 212 (1988)); *Mead Corp. v. Tilley*, 490 U.S. 714, 722-23 (1989) (applying *Chevron* deference to agency interpretations reflected in an amicus brief and several opinion letters); *Stinson v. United States*, 508 U.S. 36, 38 (1993) (holding "commentary in the [Sentencing] Guidelines Manual . . . is authoritative unless . . . inconsistent with" plain reading of guidelines); *FDIC v. Philadelphia Gear Corp.*, 476 U.S. 426, 439 (1986) (applying *Chevron* deference to a statement made by a governmental official in a public meeting).

B. The Rules of the NASD Arguably Deserve Either *Chevron* or *Skidmore* Deference

1. The Status of the NASD In Relation to the SEC

The Court's decisions leave unanswered the question of whether judicial deference should extend beyond a formal administrative agency to a self-regulatory organization such as the NASD. The unique status of the NASD, and its unique relation to the SEC in connection with the enforcement of the securities laws, supports consideration by the Court of this unique question.

The Maloney Act of 1938, 15 U.S.C. §§ 78o-3, *et seq.*, a revision to the Securities Exchange Act of 1934, authorizes the creation of one or more "national securities associations" to be registered with the SEC. 15 U.S.C. § 78o-3(a). The NASD was established as a national securities association pursuant to the Maloney Act and is the primary body regulating the brokerage industry in the United States. *P'ship Exch. Sec. Co. v. NASD*, 169 F.3d 606, 606 (9th Cir. 1999). Through the Maloney Act, Congress delegated governmental power to the NASD to enforce "'compliance by members of the industry with both the legal requirements laid down in the Exchange Act and ethical standards going beyond those requirements.'" *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. NASD*, 616 F.2d 1363, 1367

(5th Cir. 1980) (quoting S. Rep. No. 94-75, 94th Cong., 1st Sess. 23 (1975), 1975 U.S.C.C.A.N. pp. 179, 201). *See also Austin Mun. Sec., Inc. v. NASD*, 757 F.2d 676, 680 (5th Cir. 1985) (same); *P'ship Exch.*, 169 F.3d at 608 (holding that the NASD exercises "quasi-governmental powers").

In order to become registered with the SEC, the NASD has had to satisfy the SEC that it has met all of the standards set out in the Maloney Act. *See generally* 15 U.S.C. § 78o-3(b). Moreover, under the Maloney Act, the SEC has strict supervisory responsibilities over the NASD, such that the NASD is subject to the SEC's extensive oversight, supervision and control on an ongoing basis. 15 U.S.C. § 78s(a)(3). The SEC has the authority to suspend or revoke the registration of the NASD, or censure or restrict its activities, functions, and operations and execute further sanctions. 15 U.S.C. §§ 78u(d)(1), (d)(3)(A). The NASD is required to file with the SEC, in accordance with SEC rules, any of the NASD's proposed rules or rule changes, and all rules and changes must be approved by the SEC. *See* 15 U.S.C. § 78s(b) and 17 C.F.R. 240.19b-4. In addition, the SEC possesses the authority to approve, abrogate or amend an NASD rule, if necessary to effectuate the purpose of the Act. *See* 15 U.S.C. § 78s(b)-(c). Finally, the SEC has plenary review powers over any disciplinary action taken by the NASD. 15 U.S.C. § 78o-3(h) and §§ 78s(d) and (e).

In *United States v. National Association of Securities Dealers, Inc.*, 422 U.S. 594, 710 (1975) (hereinafter "*NASD*"), the Supreme Court described the function and role of the NASD as follows:

> The NASD is registered under § 15A of the Securities Exchange Act of 1934, 15 U.S.C. § 78o-3, the so-called Maloney Act of 1938. The Maloney Act supplements the Securities and Exchange Commission's regulation of the over-the-counter markets by providing a system of cooperative self-regulation through voluntary associations of brokers and dealers. The Act provides that associations may

> register with the Commission pursuant to specified terms and conditions, and authorizes them to promulgate rules designed to prevent fraudulent and manipulative practices; to promote equitable principles of trade; to safeguard against unreasonable profits and charges; and generally to protect investors and the public interest. § 78o-3(b)(8). The Act also authorizes the SEC to exercise a significant oversight function over the rules and activities of the registered associations. *See, e.g.*, §§ 78o-3(b), (e), (h), (j), and (k). The NASD is presently the only association registered under this Act.

Id. at 700 n.6. In the *NASD* decision, the Court recognized the significant interaction and interplay of the SEC and NASD:

> In view of the scope of the SEC's regulatory authority over the activities of the NASD, the Government's decision to withdraw from direct attack on the association's rules was prudent. The SEC's supervisory authority over the NASD is extensive. Not only does the Maloney Act require the SEC to determine whether an association satisfies the strict statutory requirements of that Act and thus qualifies to engage in supervised regulation of the trading activities of its membership, 15 U.S.C. § 78o-3(b), it requires registered associates thereafter to submit for Commission approval any proposed rule changes, § 78o-3(j). The Maloney Act additionally authorizes the SEC to request changes in or supplementation of association rules, a power that recently has been exercised with respect to some of the precise conduct questioned in this litigation . . . If such a request is not complied with, the SEC may order such changes itself. § 78o-3(k)(2).

Id. at 732-33.

Thus, it is clear that the NASD, the only national securities organization registered under the Maloney Act, is not an ordinary

non-profit corporation. Rather, the Maloney Act has empowered the NASD to make rules and to act — subject to pervasive supervision of the SEC — as a quasi-governmental agency. *See Nassau Sec. Serv. v. SEC*, 348 F.2d 133 (2d Cir. 1965); *R. H. Johnson v. SEC*, 198 F.2d 690 (2d Cir.), *cert. denied*, 344 U.S. 855 (1952). Indeed, actions of the NASD have consistently been held to be within the limits of the adjudicatory, prosecutorial, or regulatory function of a government or quasi-government official and the NASD has therefore been given immunity from private civil suits. *DL Capital Group LLC v. NASDAQ Stock Market, Inc.*, C.A. No. 03 Civ. 9730 (CSH), 2004 U.S. Dist. LEXIS 7955, at *17 (S.D.N.Y. May 5, 2004) (reviewing "unbroken line of authority" on immunity granted to the NASD). *See also Austin*, 757 F.2d at 688-691, (finding that the actions of the disciplinary officers of the NASD who serve as "surrogates for the SEC, . . . should receive the same immunity their principles possess.") (citing and relying on *Butz v. Economou*, 438 U.S. 478 (1978)); *D'Alessio v. New York Stock Exch., Inc.*, 258 F.3d 93, 105 (2d Cir. 2001) ("a SRO . . . may be entitled to immunity from suit for conduct falling within the scope of the SRO's regulatory and general oversight functions.").[8]

2. The NASD's Rules and Positions In This Case Were Deserving of Judicial Deference and Would Have Materially Affected the Lower Court's Disclosure Analysis

NASD "Notices to Members," in conjunction with the "Conduct Rules" to which they relate, state *mandatory*

8. The NASD functions in the same way as an administrative agency in at least three significant ways. *First*, like an administrative agency, the NASD employs specific rulemaking procedures to issue its rules, which are policy decisions that affect a broad class of individuals. *Second*, like an administrative agency, the NASD has developed an independent review policy analogous to judicial review of agency actions. *Third*, like an administrative agency, the NASD allows an individualized hearing for specific disputes, similar to agency adjudication. *See* Administrative Procedure Act, 5 U.S.C. §§ 553, 554 and 706 (2000).

disclosure requirements. As discussed above, NASD's Notices and Conduct Rules are issued by the NASD with the knowledge and implicit approval of the SEC, and NASD member broker-dealers are required by statute to comply with all NASD Conduct Rules. *See* 15 U.S.C. § 78(o).[9] Repeated enforcement actions can result in the broker-dealer being expelled from NASD membership and barred from the securities industry, especially after an NASD Notice to Members has reminded sellers of their obligations under the Conduct Rules. *See* 15 U.S.C. § 78o-3(b)(7) (stating that an association of brokers or dealers cannot be registered unless the rules of the association "provide that . . . its members and persons associated with its members shall be appropriately disciplined for violation of any provision of this title, the rules or regulations thereunder . . . *or the rules of the association*, by expulsion, suspension . . . or any other fitting sanction") (emphasis added).

Specific to this case, beginning in 1994 the NASD issued a series of Conduct Rules and Notices to Members specifically concerning communications by broker-dealers with the investing public regarding variable annuities. These rules and notices addressed the disclosures required to be made to persons purchasing tax-deferred variable annuities for already tax-deferred accounts such as IRAs and other similar tax-deferred accounts. In particular, Notice to Members 99-35 states:

> When a registered representative recommends the purchase of a variable annuity for any tax-qualified retirement account (*e.g.*, 401(k) plan, IRA), *the registered representative should disclose to the customer that the tax deferred accrual feature is*

9. All of those who underwrite or distribute variable annuities are required to be members of the NASD. NASD Notice to Members 99-35 states (in "Background" at 229): "A distributor of variable annuity contracts to individuals is required to register as a broker/dealer under the Securities Exchange Act of 1934 and become a member of the NASD. The distribution of variable annuity contracts is subject to NASD rules." Respondent ASM, the underwriter of the annuities at issue, is a member of the NASD.

> *provided by the tax-qualified retirement plan and that the tax deferred accrual feature of the variable annuity is unnecessary. . . .*

NASD Notice to Members 99-35 (1999), Appendix E at 25a ¶ 11 ("The NASD Reminds Members of Their Responsibilities Regarding the Sales of Variable Annuities") (emphasis added), *citing*, *e.g.*, NASD Conduct Rule IM-2210-2 (1994) ("Communications with the Public About Variable Life Insurance and Variable Annuities") and other Rules and Notices.[10]

In connection with the violation of these rules and notices, the NASD has followed through with regulatory inspections, deficiency letters, and enforcement actions. One of the more recently publicized NASD enforcement actions was against American Express Financial Advisors Inc., which was censured and fined $350,000 for sales practice and supervision violations in connection with the failure of its registered representatives "to disclose that variable annuities do not provide the benefit or advantage of tax deferred earnings when purchased in qualified plans." The *AmEx* settlement stated that:

> Certain of the Firm's disclosure documents, including prospectuses . . . omitted material facts regarding qualified annuities. . . . [T]hat material did not disclose that variable annuities do not provide

10. The NASD Notices to Members constitute "interpretations" of the NASD's rules, and the issuance of such an "interpretation" is considered to be a legitimate exercise of the NASD's rule-making authority. The NASD's by-laws clearly legitimize "interpretation" as one form of rule-making, and the SEC has on numerous occasions treated the NASD interpretations as rules for purposes of exercising its statutory power of review over NASD "rules." *See* 15 U.S.C. § 78o-3(k)(1); *In re the Rules of the National Association of Securities Dealers, Inc.*, 17 S.E.C. 459 (1944) (SEC upheld the NASD's 5 per cent mark-up policy, which was announced at least in part in an "interpretation" of the NASD Rule of Fair Practice); *Harwell v. Growth Programs, Inc.*, 315 F. Supp. 1184, 1189-96 (W.D. Tex. 1970) (holding the NASD issuance of an "interpretation" to be a "legitimate exercise of the NASD's rule-making authority").

> any additional tax deferral when purchased in a qualified plan. Many of the Firm's disclosure documents also did not differentiate between sales into qualified plans and other sales. *NASD Dep't of Enforcement v. American Express Financial Advisors Inc.* No. CAF020057, NASD Letter of Acceptance, Waiver and Consent at 4 (Nov. 12, 2002).

In another NASD enforcement action against American United Life Insurance Company (AUL), the NASD alleged that AUL violated NASD Conduct Rules 2210, among other NASD Conduct Rules, by using prospectuses and other sales literature that "failed to affirmatively state that variable annuity contracts purchased for tax-deferred plans provide no additional tax benefit to the purchaser beyond those tax benefits that are inherent in qualified retirement plans." *NASD Dep't of Enforcement v. American United Life Ins. Co.*, No. C05010011 (NASD Regulation, Inc. Office of Hearing Officers, Order Accepting Offer of Settlement at 2) (2002).

There is little question that the analysis in the instant case as to whether all material information was disclosed would have been drastically different if the Second Circuit had given any sort of deference to the NASD rules and notices, instead of ignoring those rules and notices in its disclosure analysis. The question now presented to this Court is whether the NASD's disclosure rules and its interpretations of those rules in formal NASD enforcement proceedings should receive judicial deference. The Court in *Mead* appears to have invited this question by stating:

> This Court in *Chevron* recognized that Congress not only engages in express delegation of specific interpretive authority, but that "sometimes the legislative delegation to an agency on a particular question is implicit." Congress, that is, may not have expressly delegated authority or responsibility to implement a particular provision or fill a particular gap.

> Yet it can still be apparent from the agency's generally conferred authority and other statutory circumstances that Congress would expect the agency to be able to speak with the force of law when it addresses ambiguity in the statute or fills a space in the enacted law, even one about which "Congress did not actually have an intent" as to a particular result.

Mead, 533 U.S. at 229 (quoting *Chevron*, 467 U.S. at 842-46) (citations omitted). With the enactment of the Maloney Act, Congress arguably implicitly expected the NASD, with the oversight of the SEC, to speak with the force of law. The Court should now address whether the NASD is deserving of judicial deference, and if so whether that deference should be under a *Chevron* standard, a *Skidmore* standard, or another standard.

II. Review Is Warranted To Determine Whether The Second Circuit Contravened The Supreme Court's Deference Standards By Completely Ignoring Directly Relevant Positions Of The SEC In Granting A Motion To Dismiss

Section 10(b) of the Exchange Act states, in relevant part:

> It shall be unlawful for any person, directly or indirectly . . . (b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in *contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.*

15 U.S.C. § 78j(b) (emphasis added). Therefore, Section 10(b) expressly delegated rule-making authority to the SEC, which the SEC exercised in promulgating Rule 10b-5. Pursuant to its authority under Section 10(b) of the 1934 Act, 15 U.S.C. § 78j, the SEC promulgated Rule 10b-5. Rule 10b-5, which implements Section 10(b), provides in relevant part,

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality

> of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> * * *
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading,

17 C.F.R. § 240.10b-5. *See Basic*, 485 U.S. at 231 (Rule 10b-5 "constitutes an essential tool for enforcement of the 1934 Act's requirements.").

There is no doubt that the SEC is entitled to *Chevron* deference when it interprets its rules and regulations promulgated under the federal securities laws, including Rule 10b-5. *See Mead*, 533 U.S. at 229 ("We have recognized a very good indicator of delegation meriting *Chevron* treatment in express congressional authorizations to engage in the process of rulemaking or adjudication that produces regulations or rulings for which deference is claimed."); *SEC v. Zandford*, 535 U.S. 813, 820 (2002) (the SEC's interpretation of the securities laws controls unless Congress has clearly and unambiguously addressed the question at issue) (citing *Mead*, 533 U.S. at 229-30). Indeed, deference to SEC action or conduct "necessary to make the securities laws work" has been viewed as more important than deference to other executive agencies due to "the grave historical crises caused by the absence of regulation" in the securities industry. *See Phonetele, Inc. v. American Tel. and Tel. Co.*, 664 F.2d 716, 727 n.31 (9th Cir. 1981), *citing NASD*, 422 U.S. at 705-11 and *Gordon v. New York Stock Exch., Inc.*, 422 U.S. 654, 681-82 (1975).

As discussed above, the SEC issued a Joint Report with the NASD entitled "Joint SEC/NASD Report on Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products," in which it clearly and unequivocally concluded that the failure to disclose the "lack of additional tax benefit" when purchasing a variable for a tax-qualified account was a "weak

practice" which could constitute a violation of the anti-fraud provisions of the securities laws. The SEC, as discussed above, also has repeatedly reiterated its support of the NASD's position on this issue. The Second Circuit disregarded the clearly stated position of the SEC on the precise question in the case, finding that all material disclosures were made as a matter of law. The Court should consider whether such a disregard contravened this Court's precedents of, *inter alia*, *Chevron*, *Mead* and *Christensen*, regarding the deference owed by a court to the SEC.

III. Review Is Warranted To Determine Whether The Second Circuit Contravened The Supreme Court's Precedents When It Dismissed A Case On The Pleadings Based On A Finding That All Material Disclosures Had Been Made As A Matter Of Law, While Ignoring Directly Relevant Rules And Decisions Of The SEC and NASD

Review by the Supreme Court is also necessary to determine whether the Second Circuit's *de novo* dismissal of the case conflicts with the Court's precedents by exceeding the proper role of a court in conducting a materiality analysis under the federal securities laws.

In *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), the Court explicitly defined the standard of "materiality" under the securities laws. The *TSC Industries* Court concluded, in the proxy-solicitation context, that

> an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . . Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.

Id. at 449.[11] The *TSC Industries* Court was careful not to set too low a standard of materiality because "it was concerned that a

11. Similarly, whether a statement, as opposed to an omission, is actionable under the federal securities laws requires a determination as

(Cont'd)

minimal standard might bring an overabundance of information within its reach, and lead management 'simply to bury the shareholders in an avalanche of trivial information — a result that is hardly conducive to informed decision-making.'" *Basic*, 485 U.S. at 231 (citing *TSC Industries*, 426 U.S. at 448-49). In *Basic*, 485 U.S. at 230-31, the Court expressly adopted the *TSC Industries* standard of materiality in the Section 10(b) and Rule 10b-5 context.

As the *TSC Industries* Court stated, "because the determination of materiality "requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him," the materiality determination is "peculiarly one [ ]for the trier of fact." *Id.* 426 U.S. at 450 (finding the materiality determination to be inappropriate even on summary judgment). *See also Basic*, 485 U.S. at 240 (describing the inquiry into materiality as a "fact-specific inquiry.").

Following the Supreme Court's admonitions in *TSC Industries* and *Basic*, district and appellate courts have generally declined to decide the materiality question as a matter of law unless the alleged omissions are so clearly unimportant that reasonable minds could not differ. *Compare, e.g., Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 162-65 (2d Cir. 2000) (declining to rule on materiality); *Gebhardt v. Conagra Foods, Inc.*, 335 F.3d 824, 830 (8th Cir. 2003) (same) to *Klein v. Gen. Nutrition Cos.*, 186 F.3d 338, 342-43 (3d Cir. 1999) (ruling on

(Cont'd)
to whether the statement would mislead a reasonable investor in light of other omitted information. As the Court stated in *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991):

> not every mixture with the true will neutralize the deceptive. If it would take a financial analyst to spot the tension between the one and the other, whatever is misleading will remain materially so, and liability should follow. The point of a proxy statement, after all, should be to inform, not to challenge the reader's critical wits.

Id. at 1097-98.

materiality); *Kapps v. Torch Offshore, Inc.*, 379 F.3d 207, 216 (5th Cir. 2004) (same). While there is no absolute guide as to what type of information is so "insignificant" that the issue of materiality can be taken out of the province of the jury, and such determinations are necessarily highly case-specific, the Second Circuit's disregard of specific SEC and NASD guidance in connection with its Rule 12(b)(6) analysis arguably went beyond what is permissible under the Supreme Court's precedents.[12]

This is a particularly compelling question on a Federal Rule 12(b)(6) motion to dismiss, which is the context in which the dismissal of the instant case occurred. The Supreme Court has been clear that a court should only grant a Rule 12(b)(6) motion "if it is clear that no relief could be granted under any set of facts that could be proved consistent with the allegations." *Hishon v. King & Spalding*, 467 U.S. 69, 73 (1984) (citing *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957)). The Court has also been clear that a court's role is "necessarily a limited one,"

12. Numerous Circuit Courts that have been presented with NASD rules have specifically and repeatedly held that those rules reflect the standards by which to assess the scope of disclosure obligations under the federal securities laws. *See, e.g., Vucinich v. Paine, Webber, Jackson & Curtis, Inc.*, 803 F.2d 454, 458, 461 (9th Cir. 1986) (finding that the district court abused its discretion in excluding the testimony of plaintiff's expert concerning the rules of the NYSE and the NASD, because the testimony was "highly relevant and far from prejudicial 'because the rules reflect the standard to which all brokers are held.'") (citation omitted); *Mihara v. Dean Witter & Co., Inc.*, 619 F.2d 814, 824 (9th Cir. 1980) (same); *O'Connor v. R.F. Lafferty & Co.*, 965 F.2d 893, 898 (10th Cir. 1992) (a violation of NYSE and NASD rules can be used to determine whether a violation of the securities laws has occurred); *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 333 (5th Cir. 1981) (same); *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594, 601 (2d Cir. 1978) (specifically upholding the trial judge's jury instruction that rules of the NASD "may be considered by you as an expression of the security industry itself concerning what constitutes proper conduct, and the violation of those rules under certain circumstances amounts to fraud under the federal securities laws. . . .").

and the issue on a Rule 12(b)(6) motion is not whether a plaintiff will ultimately prevail "but whether the claimant is entitled to offer evidence to support the claims." *Scheuer v. Rhodes*, 416 U.S. 232, 236 (1974). The Court has also been clear that a pleading must be read in the light most favorable to the pleader. *Conley*, 355 U.S. at 45-46. Deciding that all material disclosures were made on a Rule 12(b)(6) motion, where specific NASD and SEC guidance clearly points to the materiality of the allegedly undisclosed information, underscores the conflict of the Second Circuit's decision with *TSC Industries* and *Basic*.

CONCLUSION

For all the foregoing reasons, Petitioners respectfully request that the Supreme Court issue a writ of certiorari to review the Second Circuit's opinion in this case.

Respectfully submitted,

DANIEL W. KRASNER*
MICHAEL JAFFE
ROBERT B. WEINTRAUB
KATE MCGUIRE
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270 Madison Avenue
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Attorneys for Petitioners

* *Counsel of Record*

APPENDIX

APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT FILED MAY 14, 2004

UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

No. 03-7902

96 Fed. Appx. 779; 2004 U.S. App. LEXIS 9461; Fed. Sec. L. Rep. (CCH) P92,827

DIANE C. DONOVAN, on behalf of herself and all others similarly situated,

Plaintiff,

JAY HENDRICKSON, ROSE HENDRICKSON, KATHLEEN O'BRIEN,

Plaintiffs-Appellants,

v.

AMERICAN SKANDIA LIFE ASSURANCE CORPORATION, AMERICAN SKANDIA MARKETING, INCORPORATED, AMERICAN SKANDIA INVESTMENT CORPORATION, ABC CORP., INC., ABC CORP., INC. 1 through ACB CORP., INC. 99, LMN CORP., INC. 1 through LMN CORP., INC. 99,

Defendants-Appellees.

Appendix A

JUDGES: PRESENT: HONORABLE REENA RAGGI, HONORABLE RICHARD C. WESLEY, Circuit Judges, HONORABLE SIDNEY H. STEIN,[1] District Judge.

OPINION:

SUMMARY ORDER

UPON DUE CONSIDERATION, IT IS HEREBY ORDERED, ADJUDGED, AND DECREED that the district court's judgments entered August 4, 2003, and September 2, 2003, are AFFIRMED.

On December 12, 2002, Plaintiffs-Appellants filed suit, on behalf of themselves and all other persons similarly situated, in the district court under *sections 10(b)* and *20 of the Securities and Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § § 78j(b), 78t(a)*; *Rule 10b-5, 17 C.F.R. § 240.10b-5*; *sections 11, 12(a)(2), and 15* of the Securities Act of 1933 ("Securities Act"), *15 U.S.C. § § 77k, 77l* and *77o*; and *section 34(b) of the Investment Company Act of 1940*, id. *§ 80a-33(b)*, charging that Defendants-Appellees misled prospective investors by suggesting in a prospectus for deferred annuities that such annuities may be appropriate investments to fund qualified retirement plans, without warning that the tax-deferred feature of deferred annuities would not provide an additional tax benefit because earnings in qualified retirement plans are already deferred. Plaintiffs

1. The Honorable Sidney H. Stein of the United States District Court for the Southern District of New York, sitting by designation.

further alleged control-person liability under *section 20 of the Exchange Act, 15 U.S.C. § 78t(a)*, and *section 15 of the Securities Act*, id. *§ 77o*.

The district court dismissed plaintiffs' claims with prejudice pursuant to *Fed. R. Civ. P. 12(b)(6)*, concluding that the prospectus provided by defendants did not contain a misstatement of material fact nor did it omit a material fact. See *Donovan v. Skandia Inv. Holding Corp., 2003 U.S. Dist. LEXIS 13129, No. 02 CV 9859, 2003 WL 21757260 (S.D.N.Y. Jul. 31, 2003)*. The district court also denied plaintiffs' motion pursuant to *Federal Rule of Civil Procedure 59(e)* to alter the judgment to without prejudice and to amend the pleadings. See *Donovan v. American Skandia Life Assur. Corp., 217 F.R.D. 325 (S.D.N.Y. 2003)*.

Plaintiffs now appeal, arguing that dismissal of the Securities Act and Exchange Act claims was improper and that the district court abused its discretion by denying the *Rule 59(e)* motion; they have withdrawn their appeal of the dismissal of the *Investment Company Act* claim.

We review a dismissal pursuant to *Rule 12(b)(6)* de novo. See *Ganino v. Citizens Utils. Co., 228 F.3d 154, 161 (2d Cir. 2000)*. Dismissal is appropriate only if, accepting the material facts alleged in the complaint as true and drawing all reasonable inferences in plaintiffs' favor, we conclude that plaintiffs are not entitled to relief as a matter of law. See id.

To state a claim under *section 10(b)* of the Exchange Act, *Rule 10b-5*, or *sections 11 or 12(a)(2)* of the Securities Act of 1933, a plaintiff must plead facts establishing that

defendants made an untrue statement of a material fact or made a material omission. See *15 U.S.C. § 77k(a)* (providing that any signer, officer of the issuer, or underwriter shall be liable for a registration statement that "contains an untrue statement of a material fact or omits to state a material fact"); id. *§ 77l* (imposing liability for making a securities offering "by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements . . . not misleading"); see *Ganino v. Citizens Utils. Co., 228 F.3d at 161* ("To state a claim under *§ 10(b)* and the corresponding *Rule 10b-5*, a plaintiff must plead that defendant . . . made a materially false statement or omitted a material fact. . . .").

Plaintiffs submit that NASD Notice 99-35 and SEC Form N-4 imposed a duty on defendants to include an express warning in the prospectus that funding a qualified retirement plan with deferred annuities is "unnecessary" because earnings in qualified retirement plans are already deferred, and that the failure to include such a warning constitutes a material omission.

As the district court correctly observed, neither NASD Notice 99-35 nor SEC Form N-4 imposes a duty on defendants to include in its prospectuses the warning sought by plaintiffs. By its terms, NASD Notice 99-35 applies only to registered representatives recommending the purchase of a variable annuity; it does not require annuity issuers to include a warning in a prospectus or other offering documents. Furthermore, even if the Notice did apply to issuers, the prospectus challenged in this case does not

recommend the purchase of annuities; it says only that annuities "may be [a] suitable" investment. Indeed, the prospectus specifically advises prospective investors to seek professional tax advice before purchasing annuities for use in a qualified plan. Prospectus at 41.

As to SEC Form N-4, the form requires issuers to describe the tax consequences of investing in a deferred annuity, and if the tax consequences vary depending on the use of the annuity, to describe those variations as well. SEC Form N-4, at 13. Although acknowledging that the prospectus adequately explains the ordinary tax consequences of an annuity, namely, that the gains on the annuity are not taxed until a distribution is made, plaintiffs suggest that using an annuity to fund a qualified retirement plan results in a variation in the tax consequences that requires explicit disclosure. We see the matter differently. Insofar as deferral is concerned, investing in a qualified plan does not change the tax consequences of investing in an annuity: whether or not the annuity is used to fund a qualified retirement plan, taxes will not be assessed until a distribution is made.

Nor did the failure to include the warning sought by plaintiffs constitute a material omission. An omission is material if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available." *Basic, Inc. v. Levinson, 485 U.S. 224, 231-32, 99 L. Ed. 2d 194, 108 S. Ct. 978 (1988)*; accord *Ganino v. Citizens Utils. Co., 228 F.3d 154 at 161 at 161-62*. Here, the prospectus clearly states that the investment gains on annuities are not taxable "until an amount is received

(a 'distribution')," Prospectus at 39, and that contributions to qualified retirement plans are "not taxable until distributions are made," Prospectus at 42. From this information, the reasonable investor would know that, since taxes on qualified retirement plans are not assessed until a distribution is made, funding a replacement fund with deferred annuities would provide no additional tax advantage. Adding a warning stating that the tax-deferred feature of a deferred annuity is "unnecessary" when the annuity is to fund a qualified retirement plan investments thus would not have "significantly altered the total mix of information" in the prospectus.

Accordingly, we conclude that the district court properly dismissed plaintiffs' claims under *section 10(b)* of the Exchange Act, *Rule 10b-5,* and *sections 11 and 12(a)(2)* of the Securities Act. Because plaintiffs have failed to state a claim under these provisions, their control-person claims under *section 20 of the Exchange Act, 15 U.S.C. § 78t(a),* and *section 15 of the Securities Act,* id. *§ 77o,* must be dismissed as well. See *Rombach v. Chang, 355 F.3d 164, 177-78 (2d Cir. 2004).*

Since any attempt to state a claim based upon these facts would have been futile, and the amended complaint proposed by plaintiffs would not have cured the defect, the district court did not abuse its discretion in denying the motion to alter the judgment and amend the complaint. See *Lewis ex rel. American Express Co. v. Robinson (In re American Express Co. Shareholder Litig.), 39 F.3d 395, 402 (2d Cir. 1994)*

Accordingly, the judgments of the district court are hereby AFFIRMED.

APPENDIX B — DECISION AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK FILED JULY 31, 2003

UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

02 CV 9859(MP)

2003 U.S. Dist. LEXIS 13129; Fed. Sec. L. Rep. (CCH) P92,488

July 31, 2003, Decided
July 31, 2003, Filed

DIANE C. DONOVAN, on behalf of herself and all others similarly situated, Plaintiff, – against – SKANDIA INVESTMENT HOLDING CORPORATION, ABC CORP., INC. 1 through ABC CORP., INC. 99 and LMN CORP., INC. 1 through LMN CORP., INC. 99,

Defendants.

JUDGES: MILTON POLLACK, Senior United States District Judge.

OPINIONBY: MILTON POLLACK

OPINION:

DECISION AND ORDER

I. PARTIES

Lead Plaintiffs are citizens and residents of the State of Utah who purchased deferred variable annuity products from the American Skandia Defendants in January and February

of 2000. Plaintiffs seek to bring this action as members of a class consisting of all persons who, between December 13, 1997 and October 22, 2000, were parties to a deferred annuity contract issued, underwritten, marketed [*2] or sold by defendants.

Defendant American Skandia Life Assurance Corp. ("American Skandia") is one of the largest insurance and variable annuity companies in the United States and the world. The other defendants (together with American Skandia, the "American Skandia Defendants") are holding companies or subsidiaries of American Skandia which develop, market and underwrite fixed and variable annuities.

II. FACTS

Plaintiffs bring this action individually and on behalf of all other persons similarly situated pursuant to the Securities and Exchange Act of 1934, *15 U.S.C. § § 78j(b) and 78t(a)*, and *Rule 10b-5, 17 C.F.R. § 240.10b-5*, promulgated thereunder; the Securities Act of 1933, *15 U.S.C. § § 77k, 77l and 77o*; and the Investment Company Act of 1940, *15 U.S.C. § 80a-33(b)*.

According to Plaintiffs, the American Skandia Defendants misled prospective customers into believing that deferred annuities would be appropriate investments for placement into qualified retirement plans, while failing to disclose the alleged inappropriateness and unsuitability of such a combination.

Plaintiffs are not, however, bringing any charges against the broker from whom they purchased the variable annuity. Instead, Plaintiffs bring claims against the American Skandia Defendants allegedly involved in creating the Prospectuses through which the annuities were ultimately sold.

Plaintiffs contend that as a result of defendants' misrepresentations, plaintiffs and other members of the class have incurred commissions, fees and charges in excess of what they would have paid for appropriate and suitable investments in an already tax qualified retirement plan.

III. DISCUSSION

Plaintiffs note specifically that [HN1] National Association of Securities Dealers ("NASD") Notice to Members 99-35, issued in May of 1999, requires members to disclose to the customer that the tax deferred accrual feature of the variable annuity is unnecessary where it is otherwise provided by a tax-qualified retirement plan. NASD notices, however, are not law and noncompliance therewith cannot itself constitute a violation of the federal securities laws. See *Max Marx Color & Chemical Co. Employees' Profit Sharing Plan v. Barnes, 37 F. Supp. 2d 248, 253 (S.D.N.Y. 1999)*; *Merit Ins. Co. v. Leatherby, 714 F.2d 673, 680* (7th Cir.), cert. denied, *464 U.S. 1009, 104 S. Ct. 529, 78 L. Ed. 2d 711 (1983)*. No duty of disclosure will arise directly from a NASD notice. See e.g., *Resnik v. Swartz, 303 F.3d 147 (2d Cir. 2002)* ("omission of information . . . will violate these provisions if either *the SEC regulations* specifically require disclosure . . . or the omission makes other statements . . . materially false or misleading")

(emphasis added). Plaintiffs do not contend that the SEC requirements call for NASD mandated disclosures. As for Plaintiffs' reference to SEC Form N-4, only variations in tax consequences need be disclosed. [HN2] The Prospectuses are not required to state that certain uses are "unnecessary" or offer advice as to when, for tax purposes or otherwise, to use a variable annuity in a retirement plan.

To be actionable, therefore, the omissions complained of must make other statements in the prospectus misleading and there must be a substantial likelihood that the disclosure of the omitted facts would have been viewed by the reasonable investor to have significantly altered the total mix of information made available. See *Basic Inc. v. Levinson, 485 U.S. 224, 231-32, 99 L. Ed. 2d 194, 108 S. Ct. 978 (1988).*

Although the Prospectuses undeniably indicate that a variable annuity may be used as an investment vehicle for a qualified retirement plan, it is not true, as Plaintiffs state, that this is never appropriate. [HN3] NASD Notice 99-35 itself states that a registered representative may recommend a variable annuity for a tax-qualified retirement account "when its other benefits, such as lifetime income payments, family protection through the death benefit, and guaranteed fees" support the recommendation.

Nor do the allegedly omitted facts significantly alter the total mix of information made available. The Prospectuses clearly state that both variable annuities and tax qualified retirement plans are tax deferrable. [HN4] That is enough to alert all reasonable investors to the fact that it is unnecessary, if solely for tax reasons, to use a variable annuity to fund a

tax-deferred retirement account.[1] See *In re NBTY, Inc. Sec. Litig., 224 F. Supp. 2d 482, 495 (E.D.N.Y. 2002)*; *In re Ultimate Corp. Sec. Litig., 1989 U.S. Dist. LEXIS 8330, No. 86 CIV. 5944 (CSH), 1989 WL 79372,* at *5 (S.D.N.Y. July 11, 1989) ("Liability does not arise from the failure to disclose that which should be obvious to the average investor."). The other benefits of variable annuities are also clearly set forth, as well as the fee structure for purchase of the annuities.

The disclosures in the Prospectuses, taken in context, conclusively disprove the materiality of the alleged omissions and are thus fatal to the Plaintiffs' claims. Moreover, as the Prospectuses were issued more than two years before the filing of this suit, the disclosures therein also put the Plaintiffs on inquiry notice of their claims such that the statute of limitations bars their action.[2] And, having failed to allege a primary violation of the securities laws, Plaintiffs' claims of control person liability will also fail.

---

1. The Prospectuses further warn Plaintiffs that "before purchasing an Annuity for use in a qualified plan, you should obtain competent tax advice, both as to the tax treatment and suitability of such an investment." Gross Decl., Ex. B at 41.

2. The claims of Diane C. Donovan, one of the four lead plaintiffs in this action, are further barred by the statute of limitations because Ms. Donovan appears to have been *actually aware* of the alleged fraud more than two years before the first complaint was filed on December 13, 2002. Her claim was voluntarily withdrawn by a letter to this Court received on July 29, 2003.

IV. CONCLUSION

For the reasons set forth above, Defendants' motion to dismiss with prejudice is granted.

SO ORDERED.

Dated: July 31, 2003

MILTON POLLACK

Senior United States District Judge

APPENDIX C — DECISION AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK FILED SEPTEMBER 2, 2003

UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

02 CV 9859(MP)

217 F.R.D. 325; 2003 U.S. Dist. LEXIS 15169; Fed. Sec. L. Rep. (CCH) P92,498

September 2, 2003, Decided

September 2, 2003, Filed

DIANE C. DONOVAN, on behalf of herself and all others similarly situated, Plaintiff, - against - AMERICAN SKANDIA LIFE ASSURANCE CORPORATION, AMERICAN SKANDIA MARKETING, INCORPORATED, AMERICAN SKANDIA INVESTMENT HOLDING CORPORATION, ABC CORP., INC. 1 through ABC CORP., INC. 99 and LMN CORP., INC. 1 through LMN CORP., INC. 99,

Defendants.

JUDGES: MILTON POLLACK, Senior United States District Judge.

OPINION BY: MILTON POLLACK

Appendix C

OPINION:

ON MOTION TO ALTER JUDGMENT AND AMEND COMPLAINT

POLLACK, Senior District Judge

DECISION AND ORDER

Where a proposed amended complaint cannot itself survive a motion to dismiss, leave to amend would be futile and may clearly be denied. See *In re American Exp. Co. Shareholder Litig., 39 F.3d 395, 402 (2d Cir. 1994)* ("leave to amend may be denied if the amendment would be futile"); see also *Emergent Capital Inv. Management, LLC v. Stonepath Group, Inc., 195 F. Supp. 2d 551, 563 n.4 (S.D.N.Y. 2002)* (where plaintiff was given the opportunity to amend its complaint and submitted substantially the same complaint, the Court found no need to grant subsequent motion to submit yet another non-viable complaint). Plaintiffs themselves admit that "should the motion be granted, any motion to dismiss likely would present precisely the same arguments made in the first motion to dismiss." Plaintiff's Memo of Law in Support of Motion at 5

For the reasons set forth herein and in this Court's decision and order dated July 31, 2003, Plaintiffs' motion to alter the judgment and amend the complaint is denied. Plaintiffs' main amendment would be to retract their hasty statement that it is "never appropriate" to fund a retirement savings account with a variable annuity. Instead, plaintiffs propose a formulation that is admittedly only a semantic

difference. Plaintiffs' proposed amended complaint would now allege that it is "generally not appropriate" to fund a retirement savings account with a variable annuity. Nothing in plaintiffs' proposed amendment, however, does anything to challenge this Court's findings: (1) that NASD notices are not law and do not take the place of federal securities laws; (2) that SEC Form N-4 does not require a prospectus to state that certain uses of variable annuities are unnecessary or require a prospectus to offer advice as to when, for tax purposes or otherwise, to use a variable annuity in a retirement plan; (3) that the disclosures in the prospectus already served to alert all reasonable investors to the fact that it is unnecessary, if solely for tax reasons, to use a variable annuity to fund a tax-deferred retirement account; or (4) that because the prospectuses were issued more than two years before the filing of the suit, the disclosures therein also put the plaintiffs on inquiry notice of their claims such that the statute of limitations bars their action.

The motion to alter the judgment and amend the complaint is denied.

SO ORDERED.

Dated: September 2, 2003

MILTON POLLACK

Senior United States District Judge

APPENDIX D — ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT DENYING PETITION FOR REHEARING AND REHEARING EN BANC FILED JULY 30, 2004

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT
THURGOOD MARSHALL U.S. COURT HOUSE
40 FOLEY SQUARE
NEW YORK 10007

03-7902-cv(L), 03-9018-cv (CON)

Roseann B. MacKechnie
CLERK

As a stated term of the United States Court of Appeals for the Second Circuit, held at the Thurgood Marshall United States Courthouse, Foley Square, in the City of New York, on the 30th day of July two thousand four.

DIANE C. DONOVAN, on behalf of herself and all others similarly situated,

Plaintiff,

JAY HENDRICKSON, ROSE HENDRICKSON and KATHLEEN O'BRIEN,

Plaintiffs-Appellants,

Appendix D

v.

AMERICAN SKANDIA LIFE ASSURANCE CORPORATION, AMERICAN SKANDIA MARKETING INCORPORATED, AMERICAN SKANDIA INVESTMENT CORPORATION, ABC CORP., INC., ABC CORP. INC. 1 THROUGH ACB CORP. INC. 99, LMN CORP., INC. 1 THROUGH LMN CORP., INC. 99,

Defendants-Appellees.

A petition for panel rehearing and a petition for rehearing en banc having been filed herein by the appellants Jay Hendrickson, Rose Hendrickson and Kathleen O'Brien.

Upon consideration by the panel that decided the appeal, it is Ordered that said petition for rehearing is **DENIED.**

It is further noted that the petition for rehearing en banc has been transmitted to the judges for the court in regular active service and to any other judge that heard the appeal and that no such judge has requested that a vote be taken thereon.

For the Court,

Roseann B. MacKechnie, Clerk

By: s/ [illegible]
Motion Staff Attorney

APPENDIX E — NASD NOTICE TO MEMBERS 99-35

The NASD Reminds Members Of Their Responsibilities Regarding The Sales Of Variable Annuities

Suggested Routing

Senior Management

* * *

Executive Representatives

* * *

Legal & Compliance

* * *

Operations

* * * *

Executive Summary

National Association of Securities Dealers, Inc. (NASD®) Rule 3010 requires each member to establish and maintain a system to supervise the activities of each registered representative and associated person in order to achieve compliance with the securities laws, regulations, and NASD rules. Variable life insurance and variable annuities are securities and their distribution is subject to NASD rules. This *Notice* focuses on deferred variable annuity sales and provides a set of guidelines that are intended to assist members in developing appropriate procedures relating to variable annuity sales to customers.

The guidelines identify areas of concern that NASD Regulation, Inc. (NASD Regulation®) would expect to be addressed in the procedures of members that offer and sell variable annuities. Although the specific procedures described are not mandatory, members should consider

supplementing their procedures to ensure that they will be adequately designed to achieve compliance with legal and regulatory requirements.

Questions concerning this *Notice* may be directed to Thomas M. Selman, Vice President, Investment Companies/Corporate Financing, NASD Regulation, at (240) 386-4533; Lawrence Kosciulek, Assistant Director, Advertising/Investment Companies, NASD Regulation, at (202) 728-8329; or Elliot R. Curzon, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8451.

Background

A variable annuity is an insurance contract that is subject to regulation under state insurance and securities laws. Although variable annuities offer investment features similar in many respects to mutual funds, a typical variable annuity offers three basic features not commonly found in mutual funds: (1) tax-deferred treatment of earnings; (2) a death benefit; and (3) annuity payout options that can provide guaranteed income for life.

A customer's premium payments to purchase a variable annuity are allocated to underlying investment portfolios, often termed subaccounts. The variable annuity contract may also include a guaranteed fixed interest subaccount that is part of the general account of the insurer. The general account is composed of the assets of the insurance company issuing the contract. The value of the underlying subaccounts that are not guaranteed will fluctuate in response to market changes and other factors. Because the contract owners

assume these investment risks, variable annuities are securities and generally must be registered under the Securities Act of 1933.

The underlying subaccounts that are not guaranteed are funded by a separate account of a life insurance company that, absent an exemption, is required to be registered as an investment company under the Investment Company Act of 1940. Variable annuities assess various fees including fees related to insurance features, *e.g.*, lifetime annuitization and the death benefit. The fees are typically deducted from customer assets in the separate account.

A distributor of variable annuity contracts to individuals is required to register as a broker/dealer under the Securities Exchange Act of 1934 and become a member of the NASD. The distribution of variable annuity contracts is subject to NASD rules.

Typically, variable annuities are designed to be long-term investments for retirement. Withdrawals before a customer reaches the age of 59 1/2 are generally subject to a 10 percent penalty under the Internal Revenue Code. In addition, many variable annuities assess surrender charges for withdrawals within a specified time period after purchase.

Generally, variable annuities have two phases: the "accumulation" phase when customer contributions are allocated among the underlying investment options and earnings accumulate; and the "distribution" phase when the customer withdraws money, typically as a lump-sum or through various annuity payment options.

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The myriad features of variable insurance products make the suitability analysis required under NASD rules particularly complex. NASD Regulation has addressed suitability issues in variable insurance products sales in *Notice to Members* 96-86. In that *Notice*, NASD Regulation stated that when recommending variable annuities or variable life insurance, the member and its registered representatives are required to make reasonable efforts to obtain information concerning the customer's financial and tax status, investment objectives, and such information used or considered reasonable in making recommendations to the customer.[1] In addition, a recent NASD disciplinary action discussed members' responsibilities under Rule 2310 (Suitability Rule) as they apply to the sale of variable life insurance. (See In the Matter of DBCC No. 8 v. Miguel Angel Cruz.[2])

Discussion

NASD Regulation has developed the following guidelines that represent a compilation of industry practices in the supervision of the sale of variable annuities. The guidelines do not mandate any specific procedure. Rather, they are designed to assist members in developing appropriate procedures relating to variable annuity sales practices. The guidelines are not comprehensive and are not intended as a substitute for the member's responsibilities under NASD Rule 3010. Moreover, the Suitability Rule requires an associated person of a member to make an independent determination whether an investment is suitable for a particular customer, taking into account the customer's investment objectives and financial needs.

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Customer Information

The Suitability Rule requires members and their registered representatives to make reasonable efforts to obtain information concerning a customer's financial and tax status, investment objectives, and such other information used or considered in making recommendations to the customer.

1. When recommending a variable annuity, members and their registered representatives should make reasonable efforts to obtain comprehensive customer information, including the customer's occupation, marital status, age, number of dependents, investment objectives, risk tolerance, tax status, previous investment experience, liquid net worth, other investments and savings, and annual income. Retention of this customer information can be made in conjunction with the maintenance of basic customer account information that is required in NASD Rule 3110.

2. A registered representative should discuss all relevant facts with the customer, including liquidity issues such as potential surrender charges and the Internal Revenue Service (IRS) penalty; fees, including mortality and expense charges, administrative charges, and investment advisory fees; any applicable state and local government premium taxes; and market risk.

3. The registered representative should seek to ensure that the variable annuity application and any other information provided by the customer to the member is complete and accurate, and promptly forwarded to a registered principal for review.

4. When a variable annuity transaction is recommended to a customer, the registered representative and a registered principal should review the customer's investment objectives, risk tolerance, and other information to determine that the variable annuity contract as a whole and the underlying subaccounts recommended to the customer are suitable. The registered principal should compare the information in the account application with other relevant information sources, *e.g.*, an account information form, to check for apparent accuracy and consistency prior to approving the transaction.

Product Information

5. The registered representative should have a thorough knowledge of the specifications of each variable annuity that is recommended, including the death benefit, fees and expenses, subaccount choices, special features, withdrawal privileges, and tax treatment.

6. To the extent practical, a current prospectus should be given to the customer when a variable annuity is recommended. Prospectus information about important factors, such as fees and expenses and the illiquidity of the product, should be discussed with the customer.

7. Under NASD Rule 2210, the registered representative may only use sales material that is approved by a registered principal of the member.

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Liquidity And Earnings Accrual

Lack of liquidity, which may be caused by surrender charges or penalties for early withdrawal under the Internal Revenue Code, may make a variable annuity an unsuitable investment for customers who have short-term investment objectives. Moreover, although a benefit of a variable annuity investment is that earnings accrue on a tax-deferred basis, a minimum holding period is often necessary before the tax benefits are likely to outweigh the often higher fees imposed on variable annuities relative to alternative investments, such as mutual funds.

8. The registered representative should inquire about whether the customer has a long-term investment objective and typically should recommend a variable annuity only if the answer to that question, with consideration of other product attributes, is affirmative. In general, the registered representative should make sure that the customer understands the effect of surrender charges on redemptions and that a withdrawal prior to the age of 59 1/2 could result in a withdrawal tax penalty. In addition, the registered representative should make sure that customers who are 59 1/2 or older are informed when surrender charges apply to withdrawals.

9. The member should develop special procedures to screen for any customer whose age may make a long-term investment inappropriate, such as any customer over a specific age. Based on certain contract features, some customers of advanced age may be unsuitable for a variable annuity investment.

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Income, Net Worth, And Contract Size Thresholds

10. Members should establish procedures to require a principal's careful review of variable annuity investments that exceed a stated percentage of the customer's net worth, and any contract in which a customer is investing more than a stated dollar amount.

Investment In Tax Qualified Accounts

Some tax-qualified retirement plans (e.g., 401(k) plans) provide customers with an option to make investment choices only among several variable annuities. While these variable annuities provide most of the same benefits to investors as variable annuities offered outside of a tax-qualified retirement plan, they do not provide any additional tax deferred treatment of earnings beyond the treatment provided by the tax-qualified retirement plan itself.

11. When a registered representative recommends the purchase of a variable annuity for any tax-qualified retirement account (*e.g.*, 401(k) plan, IRA), the registered representative should disclose to the customer that the tax deferred accrual feature is provided by the tax-qualified retirement plan and that the tax deferred accrual feature of the variable annuity is unnecessary. The registered representative should recommend a variable annuity only when its other benefits, such as lifetime income payments, family protection through the death benefit, and guaranteed fees, support the recommendation.

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12. A member should conduct an especially comprehensive suitability analysis prior to approving the sale of a variable annuity with surrender charges to a customer in a tax-qualified account subject to plan minimum distribution requirements.

Variable Annuity Replacements

13. The member firm may decide to develop an exchange or replacement analysis document or utilize an existing form authorized by a state insurance commission or other regulatory agency. If such a document is used, then (consistent with the requirements of various states) it should be completed for all variable annuity replacements and should include an explanation of the benefits of replacing one contract for another variable contract. The document also should be signed by the customer, the registered representative, and the registered principal.

14. The registered representative and the registered principal should determine, based on the information provided by the customer and their own knowledge of the product features, that replacing the existing contract with a new contract is suitable for the customer. Consideration should be given to such matters as product enhancements and improvements, lower cost structures, and surrender charges.

15. The member firm should consider developing compliance systems, such as computer programs, when available, that can monitor and identify those registered representatives whose clients have a particularly high rate of variable annuity replacements or rollovers. These

compliance systems should provide the firm with "red flags" that the firm can investigate to determine whether some of these replacements are unsuitable.

16. A retail member should adopt other measures reasonably designed to ensure that replacement sales activity by its registered representatives complies with NASD rules. Members that "wholesale" variable annuities are reminded that they are also subject to NASD rules, and that they should avoid marketing strategies that are designed primarily to encourage inappropriate replacement sales. Upon reasonable request and to the extent practical, wholesale members should assist retail broker/dealers in monitoring the replacement activity of their customers.

Endnote

[1] *Notice to Members 96-86* also listed specific factors that could be considered when recommending variable annuities and variable life insurance contracts. These factors are:

- a representation by a customer that his or her life insurance needs were already met;

- the customer's express preference for an investment other than an insurance product, the customer's inability to appreciate fully how much of the purchase payment or premium is allocated to cover insurance or their costs, and a customer's ability to understand the complexity of variable products generally;

- the customer's willingness to invest a set amount on a yearly basis;

- the customer's need for liquidity and short-term investment;

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• the customer's immediate need for retirement income; and

• the customer's investment sophistication and whether he or she is able to monitor the investment experience of the separate account.

[2] Complaint No. C8A930048 (NBCC Oct. 31, 1997)

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APPENDIX F — EXCERPTS OF AMERICAN SKANDIA PROSPECTUS REFERENCED BY THE SECOND CIRCUIT

[1] AMERICAN SKANDIA LIFE ASSURANCE CORPORATION

One Corporate Drive, Shelton, Connecticut 06484

This Prospectus describes American Skandia Xtra Credit[sm], a flexible premium deferred annuity (the "Annuity") offered by American Skandia Life Assurance Corporation ("we", "our" or "us"). The Annuity may be offered as an individual annuity contract or as an interest in a group annuity. This Prospectus describes the important features of the Annuity and what you should consider before purchasing the Annuity. We have also filed a Statement of Additional Information that is available from us, without charge, upon your request. The contents of the Statement of Additional Information are described on page 54. **The Annuity or certain of its investment options and/or features may not be available in all states. Various rights and benefits may differ between states to meet applicable laws and/or regulations.** Certain terms are capitalized in this prospectus. Those terms are either defined in the Glossary of Terms or in the context of the particular section.

WHY WOULD I CHOOSE TO PURCHASE THIS ANNUITY?

This Annuity is frequently used for retirement planning. It may be used as an investment vehicle for an IRA, SEP-IRA, Roth IRA or Tax Sheltered Annuity (or 403(b)). It may also be used for other purposes that are not "qualified" investments. The Annuity allows you to invest your money in a number of variable investment options as well as in one or more fixed investment options. You are not taxed on any investment gains the Annuity earns until you make a withdrawal from the Annuity or begin to

receive annuity payments. This feature, referred to as "tax-deferral", can be beneficial to the growth of your Account Value because money that would otherwise be needed to pay taxes on investment gains each year remains invested and can earn additional money. However, because the Annuity is designed for long-term retirement savings, a 10% penalty tax may be applied on withdrawals you make before you reach age 59 ½.

WHAT ARE SOME OF THE KEY FEATURES OF THE ANNUITY?

- The Annuity is a "flexible premium deferred annuity." It is called "flexible premium" because you have considerable flexibility in the timing and amount of premium payments. Generally, investors "defer" receiving annuity payments until after an accumulation period.

- This Annuity offers both variable and fixed investment options. If you allocate your Account Value to variable investment options, the value of your Annuity will vary daily to reflect the investment performance of the underlying investment options. Fixed investment options of different durations are offered that are guaranteed by us, but may have a Market Value Adjustment.

- The Annuity features two distinct phases – the accumulation period and the payout period. During the accumulation period your Account Value is allocated to one or more underlying investment options. The variable investment options, each a Class I Sub-account of American Skandia Life Assurance Corporation Variable Account B, invest in an underlying mutual fund portfolio. Currently, portfolios of the following underlying mutual funds are being offered: American Skandia Trust, The Alger American Fund,

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Montgomery Variable Series, Wells Fargo Variable Trust, Rydex Variable Trust, INVESCO Variable Investment Funds, Inc., Evergreen Variable Annuity Trust and ProFund VP.

- During the payout period, commonly called "annuitization," you can elect to receive annuity payments (1) for life; (2) for life with a guaranteed minimum number of payments; (3) based on joint lives; (4) for a guaranteed number of payments; or other options we may make available.

- This Annuity offers two different types of Credits. We add a Credit to your Annuity with each purchase payment we receive. We also provide an additional 1% credit on Purchase Payments made within the first year and may provide certain additional benefits if your Account Value has not reached a Target Value on its 10th anniversary.

- This Annuity offers a basic Death Benefit. It also offers two Optional Death Benefits that provide an enhanced level of protection for your beneficiary(ies) for an additional charge.

- You are allowed to withdraw a certain amount of money from your Annuity on an annual basis free of any charges. Other product features allow you to access your Account Value as necessary, although a charge may apply.

- Transfers between investment options are tax-free. You may make twelve transfers each year free of charge. We also offer several programs that enable you to manage your Account Value as your financial needs and investment performance change.

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These annuities are NOT deposits or obligations of, or issued, guaranteed or endorsed by, any bank, are NOT insured or guaranteed by the U.S. government, the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board or any other agency. ***An investment in this annuity involves certain investment risks, including possible loss of principal.***

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION OR ANY STATE SECURITIES COMMISSION NOR HAS THE COMMISSION OR ANY STATE SECURITIES COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE. **PLEASE READ THIS PROSPECTUS AND THE CURRENT PROSPECTUS FOR THE UNDERLYING MUTUAL FUNDS. KEEP THEM FOR FUTURE REFERENCE.**

FOR FURTHER INFORMATION CALL 1-800-752-6342

Prospectus Dated: May 1, 2000
ASXT-PROS-(05/2000)

Statement of Additional Information Dated: May 1, 2000
ASXTPROS

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[39] TAX CONSIDERATIONS

WHAT ARE SOME OF THE FEDERAL TAX CONSIDERATIONS OF THIS ANNUITY?

Following is a brief summary of some of the Federal tax considerations relating to this Annuity. However, since the tax laws are complex and tax consequences are affected by your individual circumstances, this summary of our interpretation of the relevant tax laws is not intended to be fully comprehensive nor is it intended as tax advice. Therefore, you may wish to consult a professional tax advisor for tax advice as to your particular situation.

HOW ARE AMERICAN SKANDIA AND THE SEPARATE ACCOUNTS TAXED?

The Separate Accounts are taxed as part of American Skandia. American Skandia is taxed as a life insurance company under Part I, subchapter L of the Code. No taxes are due on interest, dividends and short-term or long-term capital gains earned by the Separate Accounts with respect to the Annuities.

IN GENERAL, HOW ARE ANNUITIES TAXED?

Section 72 of the Code governs the taxation of annuities in general. Taxation of the Annuity will depend in large part on:

1. whether the Annuity is used by:

    - a qualified pension plan, profit sharing plan or other retirement arrangement that is eligible for special

treatment under the Code (for purposes of this discussion, a "Qualified Contract"); or

- an individual or a corporation, trust or partnership (a "Non-qualified Contract"); and

2. whether the Owner is:

- an individual person or persons; or

- an entity including a corporation, trust or partnership.

Individual Ownership: If one or more individuals own an Annuity, the Owner of the Annuity is generally not taxed on any increase in the value of the Annuity until an amount is received (a "distribution"). This is commonly referred to as a "tax deferral". A distribution can be in the form of a lump sum payment including payment of a Death Benefit, or in annuity payments under one of the annuity payment options. Certain other transactions may qualify as a distribution and be subject to taxation.

Entity Ownership: If the Annuity is owned by an entity and is not a Qualified Contract, generally the Owner of the Annuity must currently include any increase in the value of the Annuity during a tax year in its gross income. An exception from current taxation applies for annuities held by a structured settlement company, by an employer with respect to a terminated tax-qualified retirement plan, a trust holding an annuity as an agent for a natural person, or by a decedent's estate by reason of the death of the decedent. A tax-exempt entity for Federal tax purposes will not be subject to income tax as a result of this provision.

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[40] HOW ARE DISTRIBUTIONS TAXED?

Distributions from an Annuity are taxed as ordinary income and not as capital gains.

Distributions Before Annuitization: Distributions received before annuity payments begin are generally treated as coming first from "income on the contract" and then as a return of the "investment in the contract". The amount of any distribution that is treated as receipt of "income on the contact" is includible in the taxpayer's gross income and taxable in the year it is received. The amount of any distribution treated as a return of the "investment in the contract" is not includible in gross income.

- "Income on the contract" is calculated by subtracting the taxpayer's "investment in the contract" from the aggregate value of all "related contracts" (discussed below).

- "Investment in the contract" is equal to total purchase payments for all "related contracts" minus any previous distributions or portion of such distributions from such "related contracts" that were not includible in gross income. "Investment in the contract" may be affected by whether an annuity or any "related contract" was purchased as part of a tax-free exchange of life insurance, endowment, or annuity contracts under Section 1035 of the Code. Unless "after-tax" or non-deductible contributions have been made to a Qualified Contract, the "investment in the contract" for a Qualified Contract will be considered zero for tax reporting purposes.

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Distributions After Annuitization: A portion of each annuity payment received on or after the Annuity Date will generally be taxable. The taxable portion of each annuity payment is determined by a formula which establishes the ratio that the "investment in the contract" bears to the total value of annuity payments to be made. This is called the "exclusion ratio." The investment in the contract is excluded from gross income. Any additional payments received that exceed the exclusion ratio will be entirely includible in gross income. The formula for determining the exclusion ratio differs between fixed and variable annuity payments. When annuity payments cease because of the death of the person upon whose life payments are based and, as of the date of death, the amount of annuity payments excluded from taxable income by the exclusion ratio does not exceed the "investment in the contract," then the remaining portion of unrecovered investment is allowed as a deduction by the beneficiary in the tax year of such death.

Penalty Tax on Distributions: Generally, any distribution from an annuity not used in conjunction with a Qualified Contract (Qualified Contracts are discussed below) is subject to a penalty equal to 10% of the amount includible in gross income. This penalty does not apply to certain distributions, including:

- Distributions made on or after the taxpayer has attained age 59 ½;

- Distributions made on or after the death of the contract owner, or, if the owner is an entity, the death of the annuitant;

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- Distributions attributable to the taxpayer's becoming disabled;

- Distributions which are part of a series of substantially equal periodic payments for the life (or life expectancy) of the taxpayer (or the joint lives of the taxpayer and the taxpayer's Beneficiary);

- Distributions of amounts which are treated as "investments in the contract" made prior to August 14, 1982;

- Payments under an immediate annuity as defined in the Code.

- Distributions under a qualified funding asset under Code Section 130(d); or

- Distributions from an annuity purchased by an employer on the termination of a qualified pension plan that is held by the employer until the employee separates from service.

Special rules applicable to "related contracts": Contracts issued by the same insurer to the same contract owner within the same calendar year (other than certain contracts owned in connection with a tax-qualified retirement arrangement) are to be treated as one annuity contract when determining the taxation of distributions before annuitization. We refer to these contracts as "related contracts." In situations involving related contracts we believe that the values under such contracts and the investment in the contracts will be added together to determine the proper taxation of a

distribution from any one contract described under the section "Distributions before Annuitization." Distributions will be treated as coming first from income on the contract until all of the income on all such related contracts is withdrawn, and then as a return of the investment in the contract. There is some uncertainty regarding the manner in which the Internal Revenue Service would view related contracts when one or more contracts are immediate annuities or are contracts that have been annuitized. The Internal Revenue Service has not issued guidance clarifying this issue as of the date of this Prospectus. You are particularly cautioned to seek advice from your own tax advisor on this manner.

Special concerns regarding "substantially equal periodic payments": (also known as "72(t)" or "72(q)" distributions) Any modification to a program of distributions which are part of a series of substantially equal periodic payments that occur before the later of the taxpayer reaching age 59 ½ or five (5) years from the first of such payments will result in the requirement to pay the taxes that would have been due had the payments been treated as subject to tax in the years received, plus interest. This does not apply when the modification is due by reason of death or disability. It is our understanding that the Internal Revenue Service may not consider a scheduled series of distributions to qualify under Sections 72(q) or 72(t) if the holder of the annuity retains the right to modify such distributions at will, even if such right is not exercised, or, for a variable annuity, depending on how payments are structured.

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[41] **Special concerns regarding immediate annuities:** The Internal Revenue Service has ruled that the exception to the 10% penalty described above for "non-qualified" immediate annuities as defined under the Code may not apply to annuity payments under a contract recognized as an immediate annuity under state insurance law obtained pursuant to an exchange of a contract if: (a) purchase payments for the exchanged contract were contributed or deemed to be contributed more than one year prior to the annuity starting date under the immediate annuity; and (b) the annuity payments under the immediate annuity do not meet the requirements of any other exception to the 10% penalty.

Special rules in relation to tax-free exchanges under Section 1035: Section 1035 of the Code permits certain tax-free exchanges of a life insurance, annuity or endowment contract for an annuity. If an annuity is purchased through a tax-free exchange of a life insurance, annuity or endowment contract that was purchased prior to August 14, 1982, then any distributions other than as annuity payments will be considered to come:

- First, from the amount of "investment in the contract" made prior to August 14, 1982 and exchanged into the annuity;

- Then, from any "income on the contract" that is attributable to the purchase payments made prior to August 14, 1982 (including income on such original purchase payments after the exchange);

- Then, from any remaining "income on the contract"; and

- Lastly, from the amount of any "investment in the contract" made after August 13, 1982.

Therefore, to the extent a distribution is equal to or less than the investment in the contract made prior to August 14, 1982, such amounts are not included in taxable income. Further, distributions received that are considered to be a return of investment on the contract from purchase payments made prior to August 14, 1982, such distributions are not subject to the 10% tax penalty. In all other respects, the general provisions of the Code apply to distributions from annuities obtained as part of such an exchange.

On November 22, 1999, the Internal Revenue Service issued an acquiescence in the decision of the United States Tax Court in *Conway v. Commissioner* (111 T.C. 350 (1998)) that a taxpayer's partial surrender of an annuity contract and direct transfer of the resulting proceeds for the purchase of a new annuity contract qualifies as a non-taxable exchange under Section 1035 of the Internal Revenue Code. "Acquiescence" means that the IRS accepts the holding of the Court in a case and that the IRS will follow it in disposing of cases with the same controlling facts. Prior to the *Conway* decision, industry practice has been to treat a partial surrender of account value as fully taxable to the extent of any gain in the contract for tax reporting purposes and to "step-up" the basis in the contract accordingly. However with the IRS' acquiescence in the *Conway* decision, partial surrenders *may* be treated in the same way as tax-free 1035 exchanges of entire contracts, therefore avoiding current taxation of any gains in the

contract as well as the 10% IRS tax penalty on pre-age 59 ½ withdrawals. The IRS reserved the right to treat transactions it considers abusive as ineligible for this favorable partial 1035 exchange treatment. We do not know what transactions may be considered abusive. For example, we do not know how the IRS may view early withdrawals or annuitizations after a partial exchange. As of the date of this Prospectus, we continue to report partial surrenders of non-qualified annuities as subject to current taxation to the extent of any gain. However, we may change our reporting procedures to treat certain of these transactions as partial 1035 exchanges. Should we do so, we reserve the right to report transactions that may have been designed to receive partial 1035 exchange treatment as partial surrenders subject to current taxation if we, as a reporting and withholding agent, believe that we would be expected to deem a transaction to be abusive.

While the principles express in the Conway decision appear applicable to partial exchanges from life insurance, there is no guidance from the Internal Revenue Service as to whether it concurs with non-recognition treatment under Section 1035 of the Code for such transactions. In addition, please be cautioned that no specific guidance has been provided as to the impact of such a transaction for the remaining life insurance policy, particularly as to the subsequent methods to be used to test for compliance under the Code for both the definition of life insurance and the definition of a modified endowment contract.

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WHAT TAX CONSIDERATIONS ARE THERE FOR TAX-QUALIFIED RETIREMENT PLANS OR QUALIFIED CONTRACTS?

An annuity may be suitable as a funding vehicle for various types of tax-qualified retirement plans. We have provided summaries of the types of tax-qualified retirement plans with which we may issue an Annuity. These summaries provide general information about the tax rules and are not intended to be complete discussions. The tax rules regarding qualified plans are complex. These rules may include limitations on contributions and restrictions on distributions, including additional taxation of distributions and additional penalties. The terms and conditions of the tax-qualified retirement plan may impose other limitations and restrictions that are in addition to the terms of the Annuity. The application of these rules depends on individual facts and circumstances. Before purchasing an Annuity for use in a qualified plan, you should obtain competent tax advice, both as to the tax treatment and suitability of such an investment. **American Skandia does not offer all of its annuities to all of these types of tax-qualified retirement plans**.

[42] **Corporate Pension and Profit-sharing Plans:** Annuities may be used to fund employee benefits of various corporate pension and profit-sharing plans established by corporate employers under Section 401(a) of the Code including 401(k) plans. Contributions to such plans are not taxable to the employee until distributions are made from the retirement plan. The Code imposes limitations on the amount that may be contributed and the timing of distributions. The tax treatment of distributions is subject to

special provisions of the Code, and also depends on the design of the specific retirement plan. There are also special requirements as to participation, nondiscrimination, vesting and nonforfeitability of interests.

H.R. 10 Plans: Annuities may also be used to fund benefits of retirement plans established by self-employed individuals for themselves and their employees. These are commonly known as "H.R. 10 Plans" or "Keogh Plans". These plans are subject to most of the same types of limitations and requirements as retirement plans established by corporations. However, the exact limitations and requirements may differ from those for corporate plans.

Tax Sheltered Annuities: Under Section 403(b) of the Code, a tax sheltered annuity ("TSA") is a contract into which contributions may be made by certain qualifying employers such as public schools and certain charitable, educational and scientific organizations specified in Section 501(c)(3) for the benefit of their employees. Such contributions are not taxable to the employee until distributions are made from the TSA. The Code imposes limits on contributions, transfers and distributions. Nondiscrimiation requirements also apply.

Under a TSA, you may be prohibited from taking distributions from the contract attributable to contributions made pursuant to a salary reduction agreement unless the distribution is made:

- *After the participating employee attains age 59 ½;*
- *Upon separation from service, death or disability; or*
- *In the case of financial hardship (subject to restrictions).*

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Section 457 Plans: Under Section 457 of the Code, deferred compensation plans established by governmental and certain other tax exempt employers for their employees may invest in annuity contracts. The Code limits contributions and distributions, and imposes eligibility requirements as well. Contributions are not taxable to employees until distributed from the plan. However, plan assets remain the property of the employer and are subject to the claims of the employer's general creditors until such assets are made available to participants or their beneficiaries.

Individual Retirement Programs or "IRAs": Section 408 of the Code allows eligible individuals to maintain an individual retirement account or individual retirement annuity ("IRA"). IRAs are subject to limitations on the amount that may be contributed, the contributions that may be deducted from taxable income, the persons who may be eligible to establish an IRA and the time when distributions must commence. Further, an Annuity may be established with "roll-over" distributions from certain tax-qualified retirement plans and maintain the tax-deferred status of these amounts.

Roth IRAs: A form of IRA is also available called a "Roth IRA". Contributions to a Roth IRA are not tax deductible. However, distributions from a Roth IRA are free from Federal income taxes and are not subject to the 10% penalty tax if five (5) tax years have passed since the first contribution was made or any conversion from a traditional IRA was made and the distribution is made (a) once the taxpayer is age 59 ½ or older, (b) upon the death or disability of the taxpayer, or (c) for qualified first-time home buyer expenses, subject to certain limitations. Distributions from a Roth IRA that

are not "qualified" as described above may be subject to Federal income and penalty taxes.

Purchasers of IRAs and Roth IRAs will receive a special disclosure document, which describes limitations on eligibility, contributions, transferability and distributions. It also describes the conditions under which distributions from IRAs and qualified plans may be rolled over or transferred into an IRA on a tax-deferred basis and the conditions under which distributions from traditional IRAs may be rolled over to, or the traditional IRA itself may be converted into, a Roth IRA.

SEP IRAs: Eligible employers that meet specified criteria may establish Simplified Employee Pensions or SEP IRAs. Employer contributions that may be made to employee SEP IRAs are larger than the amounts that may be contributed to other IRAs, and may be deductible to the employer.

HOW ARE DISTRIBUTIONS FROM QUALIFIED CONTRACTS TAXED?

Distributions from Qualified Contracts are generally taxed under Section 72 of the Code. Under these rules, a portion of each distribution may be excludable from income. The excludable amount is the proportion of a distribution representing after-tax contributions. Generally, a 10% penalty tax applies to the taxable portion of a distribution from a Qualified Contract made prior to age 59 ½. However, the 10% penalty tax does not apply when the distribution:

- is part of a properly executed transfer to another IRA or another eligible qualified account;

- is subsequent to the death or disability of the taxpayer (for this purpose disability is as defined in Section 72(m)(7) of the Code);

[End of page 42]

(2)

04-599

Supreme Court, U.S.
FILED
JAN 4 - 2005
OFFICE OF THE CLERK

IN THE

Supreme Court of the United States

JAY HENDRICKSON, ROSE HENDRICKSON and KATHLEEN O'BRIEN, on behalf of themselves and all others similarly situated,

Petitioners,

—v.—

AMERICAN SKANDIA LIFE ASSURANCE CORPORATION, AMERICAN SKANDIA MARKETING, INCORPORATED, AMERICAN SKANDIA INVESTMENT HOLDING CORPORATION, ABC CORP., INC. 1 through ABC CORP., INC. 99, and LMN CORP., INC. 1 through LMN CORP., INC. 99,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

RESPONDENTS' BRIEF IN OPPOSITION

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QUESTIONS PRESENTED

I. Whether the United States Court of Appeals for the Second Circuit correctly found that an issuer of a variable annuities prospectus did not violate federal securities laws by failing to include in the prospectus non-mandatory language suggested in an NASD Notice To Members directed to registered representatives at the point of sale rather than the issuer of the security.

II. Whether the Second Circuit contravened this Court's precedent when it failed to consider a joint report issued by SEC staff and the NASD that was not published until after the Second Circuit's decision and, in any event, was addressed to registered representatives and did not represent the opinion of the SEC itself.

III. Whether the Second Circuit contravened this Court's precedent when it found that, as a matter of law, the variable annuities prospectus contained no material omissions because the alleged omissions did not significantly alter the total mix of information available to the investor.

RULE 14.1(B) STATEMENT

Petitioners "List of All Parties" (Pet. at iii) is accurate.

RULE 29.6 STATEMENT

Pursuant to Supreme Court Rule 29.6, Defendants-Respondents state that American Skandia Life Assurance Corporation and American Skandia Marketing, Inc. are wholly owned by American Skandia, Inc., a non-public company. American Skandia Investment Holding Corporation is the former name of American Skandia, Inc. American Skandia, Inc., is wholly owned by Skandia U.S. Inc., a non-public company. Skandia U.S. Inc. is wholly owned by Prudential Financial, Inc., a public company.

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STATEMENT OF THE CASE

Respondents are American Skandia Life Assurance Corporation ("ASLAC"), American Skandia Marketing, Inc. ("ASM") and American Skandia Investment Holding Corporation ("ASICH") (now known as American Skandia, Inc.) (collectively "American Skandia"). American Skandia issues and distributes variable annuities.

Petitioners are individuals who in early 2000 purchased American Skandia tax-deferred variable annuities —not from American Skandia—but from an independent broker-dealer, World Marketing Alliance, Inc. ("WMA"), and used the variable annuities to fund their tax-deferred qualified retirement plans. WMA is not a party to this action.

Petitioners allege that the American Skandia variable annuities prospectuses and other unspecified documents contained misstatements and omissions of material fact, in violation of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), as amended, 15 U.S.C. §§ 78j(b) and 78t(a), and Rule 10b-5 promulgated thereunder, 17 C.F.R. §240.10b-5; and Sections 11 and 12(a)(2) of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. §§ 77(k), 77(l) and 77(o). The District Court and a unanimous panel of the Second Circuit, however, held that Petitioners failed to meet the threshold requirement of pleading facts establishing that American Skandia made an untrue statement of material fact or made a material omission. Rather than accept these unequivocal and damning rejections of their argument, Petitioners seek this Court's review.

This action improperly attempts to litigate literally thousands of individual suitability determinations on a class-wide basis against American Skandia. However, American Skandia was only the issuer of the securities.

It was not responsible for—and did not make—those suitability determinations at the point of sale.

Petitioners' argument is twofold. First, they contend that the American Skandia's variable annuities prospectuses contained material misstatements in the form of categorical recommendations that Petitioners should purchase variable annuities to fund their qualified retirement plans. Petitioners argue that using a variable annuity to fund a qualified retirement plan is "virtually never suitable." (Pet. at 6.) The prospectuses, however, clearly do not make any such recommendation. Second, Petitioners contend that American Skandia's variable annuities prospectuses omitted certain language allegedly mandated by the National Association of Securities Dealers ("NASD") Notice to Members 99-35 (the "Notice" or "NTM 99-35"). (Pet. at 6.) However, the NASD Notice merely sets forth guidelines for registered representatives at the point of sale and creates no duty to disclose such material in American Skandia's prospectuses.

Petitioners' claim relies on a misleading partial quote of NTM 99-35, issued by the NASD in May of 1999. Petitioners allege that NTM 99-35 dictates that it is "never" suitable to fund a qualified retirement plan with a tax-deferred variable annuity because the qualified retirement plan is itself tax-deferred. The Notice itself refutes this central premise of Petitioners' claim. In fact, NTM 99-35 specifically states that while it provides guidelines, *they are not mandatory*. Additionally, NTM 99-35 suggests only that the registered representative of NASD broker-dealers should not recommend the use of a variable annuity in a qualified retirement plan unless its other features support the recommendation. A variable annuity combines many important features having nothing to do with the tax treatment of investment gains

(*e.g.*, a guaranteed stream of payments, highly flexible investment options and family protection through the death benefit)—features unavailable in alternative investment vehicles. Both Judge Pollack and a unanimous panel of the Second Circuit correctly recognized the false conflict between a statement American Skandia did not make, and a conclusion the NASD never reached.

Moreover, the Notice is directed to NASD broker-dealers supervising registered representatives—the very persons who, acting at the point of sale with the individual investor, are charged with making the individualized, multi-factor suitability analysis called for by the NASD's "know your customer" rule invoked by Petitioners. The Notice is *not* directed to, or binding on, variable annuities issuers responsible for the disclosure in prospectuses.

Both the District Court and the Second Circuit correctly concluded that the American Skandia variable annuities prospectuses contained no material misstatements, and fully and fairly disclosed all required material facts. These defects in Petitioners' claim could not be remedied by an amendment to the complaint, and therefore the District Court and the Second Circuit properly dismissed the action with prejudice.

REASONS FOR DENYING THE WRIT

The Petition fails to satisfy any of the criteria for a grant of certiorari. Supreme Court Rule 10(c). First, Petitioners have pointed to no important question of federal law that this Court should resolve. Petitioners' argument that NASD Rules deserve some level of judicial deference has no relevance in a case such as this one where there is no NASD Rule (or even Securities and Exchange Commission ("SEC") Rule) at issue. Peti-

tioners fundamentally mischaracterize this case. This case is about whether an issuer of a prospectus violated federal securities laws when it did not include within the prospectus non-mandatory language suggested by the NASD directed, not towards the issuer, but towards registered representatives responsible for the suitability determinations at the point of sale. Both the District Court and the Second Circuit, after painstakingly reviewing the prospectus at issue, correctly found that it did not contain any material misrepresentations or omissions.

Despite Petitioners' contention to the contrary, the Second Circuit considered and specifically found that NASD NTM 99-35 did not apply to the issuer of the prospectus. Relying on the plain language of NTM 99-35, the Second Circuit found it only applied to registered representatives making recommendations at the point of sale. Petitioners' reliance on three district court cases to demonstrate discordance among courts is unavailing and meritless, as these cases are factually distinguishable. Therefore, the issue of judicial deference to NASD Rules is nothing more than a red herring. However, were this Court to consider the issue, the NASD Notice is not deserving of judicial deference.

Second, the decisions below are consistent with this Court's precedent. Petitioners assert that the Second Circuit contravened this Court's precedent when it failed to give judicial deference to a June 2004 report issued jointly by SEC staff and the NASD. (Pet. at 25-27.) It must be noted that the Report was not published until several weeks after the Second Circuit's May 14, 2004 decision. Moreover, it is well-settled that letters or reports, which do not express the opinion of an executive or administrative agency, do not merit judicial deference. Additionally, Petitioners assert that the Second

Circuit's decision went against this Court's jurisprudence by deciding the issue of materiality as a matter of law, as opposed to allowing the trier of fact make this determination. (Pet. at 27-29.) However, here again it is well established that a court may determine materiality as a matter of law if, as here, the information allegedly omitted does not alter the total mix of information available to an investor.

Finally, even if the lower courts reached an erroneous decision below, this is insufficient to warrant this Court's review. The unanimous, but unpublished opinion of the Second Circuit has no binding or precedential effect.

In sum, the Petition fails to satisfy any of the criteria of Supreme Court Rule 10(c) meriting this Court's review. As such, the Petition for Certiorari should be denied.

I. THE PETITION PRESENTS NO IMPORTANT QUESTION OF FEDERAL LAW

This case presents no important question of federal law that this Court should address. Petitioners' argument that NASD Rules deserve some level of judicial deference mischaracterizes the facts of this case, and is nothing more than a red herring because this case is not about an NASD Rule (or even an SEC Rule, for that matter). The issue in this case is whether the prospectuses issued by American Skandia violated federal securities laws by failing to include language suggested in NASD NTM 99-35.[1]

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[1] Petitioners contend that American Skandia implicitly admitted an NASD violation when it changed the wording of its prospectuses in October of 2000 (Pet. at 7 n.2). This argument is meritless. It is well-established that a revised disclosure does not necessarily render a previous statement or disclosure inadequate or fraudulent. *See*

The District Court, per Judge Milton Pollack, and the Second Circuit fully considered and correctly decided the issues in this case. Judge Pollack thoroughly reviewed the prospectuses at issue, and found that the prospectuses correctly and adequately disclosed the tax nature of variable annuities and of qualified retirement plans. Judge Pollack carefully reviewed the prospectuses, and determined that they contained neither material misstatements nor omissions. Specifically, he found:

> Although the Prospectuses undeniably indicate that a variable annuity may be used as an investment vehicle for a qualified retirement plan, it is not true, as Plaintiffs state, that this is never appropriate. NASD Notice 99-35 itself states that a *registered representative* may recommend a variable annuity for a tax-qualified retirement account "when its other benefits, such as lifetime income payments, family protection through the death benefit, and guaranteed fees" support the recommendation. (Pet. App. B at 10a. (emphasis added).)

The Second Circuit unanimously concurred with Judge Pollack's analysis and decision. "As the district court correctly observed, neither NASD Notice 99-35 nor SEC Form N-4 imposes a duty on defendants to include in its prospectuses the warning sought by plaintiffs" (Pet. App. A at 5a.) These decisions are correct in light of the plain language of the NASD Notice.

In May of 1999, the NASD issued NTM 99-35 which "focuse[d] on deferred variable annuity sales and provide[d] a set of guidelines that [were] intended to assist members in developing appropriate procedures relating to variable annuity *sales to customers*." (Pet. App. E at

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SEC v. Geon Indus., Inc., 531 F.2d 39, 52 (2d Cir. 1976); *Stevelman v. Alias Research Inc.*, 174 F.3d 79, 84 (2d Cir. 1999).

18a (emphasis added).) The plain language of the Notice states that "the specific procedures described *are not mandatory*." (*Id.* (emphasis added).) NASD NTM 99-35 relates to NASD Conduct Rule 2310, (*i.e.*, the Suitability Rule).[2] (Pet. App. E 21a - 22a.) The Suitability Rule explains the obligation to determine whether an investment is "suitable" for a particular investor, which is an inherently individualized inquiry. *See* NASD Conduct Rule IM-2310. It requires the registered representative (*i.e.*, the broker) to consider the investor's wants, needs, risk tolerance and financial situation, amongst other factors. *See SEC Release No. 34-36383 "Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Application of the Rules of Fair Practice to Transactions in Exempted Securities and an Interpretation of its Suitability Rule*," 1995 WL 625609, at *4-5 (S.E.C. Release No. 34-36383, Oct. 17, 1995) (stating that the two most important considerations in a suitability determination are "the customer's capability to evaluate investment risk independently, and the extent to

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[2] NASD Conduct Rule 2310 states:

(a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

(b) Prior to the execution of a transaction recommended to a non-institutional customer . . . a member shall make reasonable efforts to obtain information concerning:

(i) the customer's financial status;
(ii) the customer's tax status;
(iii) the customer's investment objectives; and
(iv) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.

which the customer intends to exercise independent judgment in evaluating a member's recommendation"). This obligation is imposed on the broker's registered representative at the point of sale (*i.e.*, the point at which the investor—and his or her individual investment criteria—can be identified and considered).

Within the framework of the Suitability Rule, the NASD Notice specifically states:

> When a *registered representative recommends* the purchase of a variable annuity for any tax-qualified retirement account (*e.g.*, 401(k) plan, IRA), the *registered representative* should disclose to the customer that the tax deferred accrual feature is provided by the tax-qualified retirement plan and that the tax deferred accrual feature of the variable annuity is unnecessary. The *registered representative* should *recommend* a variable annuity only when its other benefits, such as lifetime income payments, family protection through the death benefit, and guaranteed fees, support the recommendation. (Pet. App. E at 25a (emphasis added).)

Therefore, the plain language of NASD NTM 99-35 only applies to registered representatives recommending the variable annuity.

The Second Circuit considered the plain language of NASD NTM 99-35, and specifically found that it did not apply to this case:

> As the district court correctly observed, neither NASD Notice 99-35 nor SEC Form N-4 imposes a duty on defendants to include in its prospectuses the warning sought by plaintiffs. By its terms, NASD Notice 99-35 applies only to *registered representatives* recommending the pur-

> chase of a variable annuity; it does not require annuity issuers to include a warning in a prospectus or other offering documents. (Pet. App. A at 4a. (emphasis added).)

Thus, the Second Circuit held that NTM 99-35 did not apply to American Skandia, but only to the registered representatives working at the point of sale. Notwithstanding, the Second Circuit further considered the relevance of NASD NTM 99-35, and found that it did not apply because the prospectuses did not recommend the purchase of the variable annuities:

> Even if the [NASD] Notice did apply to issuers, the prospectus challenged in this case *does not recommend the purchase of annuities*; it says only that annuities "may be a suitable" investment. Indeed, the prospectus specifically advises prospective investors to seek professional tax advice before purchasing annuities for use in a qualified plan. Prospectus at 41. (Pet. App. at 4a-5a (emphasis added).)

As Petitioners concede, and as Judge Pollack correctly found, American Skandia did not recommend that Petitioners purchase variable annuities for their retirement accounts. This determination was made by an independent broker-dealer, who Petitioners did not name as a defendant in this action. As Judge Pollack noted: "Plaintiffs are not, however, bringing any charges against the broker from whom they purchased the variable annuity." (Pet. App. B at 9a.)

Despite the plain language of NASD NTM 99-35, Petitioners argue that every other court that has decided the issue has disagreed with the Second Circuit. (Pet. 13-14.) Petitioners cite to three district court cases in support of their argument. These cases, however, do not warrant this Court's review for two reasons.

First, alleged conflict between a court of appeals and district court opinions are insufficient to warrant this Court's review. Uniformity in federal matters is achieved when this Court reviews various court decisions that are otherwise final in the absence of Supreme Court review. This is not the case.

Second, there is no conflict because the three district court cases are factually distinguishable from this case. In two of the cases, the courts found that the issuer was, in effect, acting as the registered representative—thus falling within the purview of NASD NTM 99-35. In *Drnek v. Variable Annuity Life Ins. Co.*, No. CIV 01-242-TUC-WDB, 2004 WL 1098919, at *3 (D. Ariz. May 4, 2004), the district court denied defendants' motion to dismiss, finding that because defendants sold the variable annuity directly to plaintiffs, this created a "relationship of trust between buyers and sellers . . . which would create a duty to inform the buyers" of the information contained in the NASD Notice. Similarly, in *Nelson v. Pac. Life Ins. Co.*, No. Civ. A. CV 203-131, 2004 WL 1592617, at *4 (S.D. Ga. July 12, 2004), the district court denied defendants' motion to dismiss, highlighting that plaintiffs alleged a principal-agency relationship with the registered representative who sold the variable annuity to plaintiffs. Petitioners have not alleged a principal-agency relationship between American Skandia and the registered representative who sold them the variable annuities at issue; in fact, they are unable to do so because Petitioners did not purchase the variable annuities in question from American Skandia, but from an independent broker-dealer.[3]

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[3] This same principle distinguishes the NASD enforcement cases upon which Petitioner seek to rely. *See NASD Dep't of Enforcement v. Am. Express Fin. Advisors, Inc.*, No. CAF020057, NASD Letter of Acceptance, Waiver and Consent (Nov. 12, 2002) (finding

Finally, in *Johnson v. Aegon USA, Inc.*, C.A. No. 1:01-CV-2617-CAP, 2004 U.S. Dist. LEXIS 20471 (N.D. Ga. Sept. 20, 2004), the district court made a factual determination regarding the disclosure in a prospectus different from the one at issue here. Petitioners have not provided any evidence that there is any similarity between American Skandia's prospectuses and those at issue in *Johnson*. The fact that the district court in *Johnson* denied defendants' motion to dismiss after reviewing a different prospectus does not conflict with the Second Circuit's opinion. That three district court opinions, interpreting different prospectuses and under different factual circumstances, reached different conclusions than the Second Circuit, does not call the Second Circuit's opinion into question.

In arguing that NASD Rules deserve judicial deference Petitioners mischaracterize this case, because there is no NASD Rule at issue. Here, the document at issue is simply an NASD Notice to Members, which the NASD recognizes is not mandatory.

An NASD Notice to Members, which only suggests guidelines, does not deserve judicial deference. In its own words, the NASD is a private not-for-profit corporation chartered in Delaware. *See NASD Respondent's Brief in Opposition On Petition for Writ of Certiorari in Desiderio v. NASD, Inc.*, Case No. 99-1285, 1999 WL 33640362, at *2 (U.S.); *see also Desiderio v. NASD, Inc.*, 191 F.3d 198, 206 (2d Cir. 1999), *cert. denied*, 531 U.S. 1069 (2001) (holding the NASD is a private—not

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registered representative violated NASD Conduct Rules in enforcement action arising out of registered representative's failure to make certain oral disclosures at the point of sale); *NASD Dep't of Enforcement v. Am. United Life Ins. Co.*, No. C05010011, NASD Regulation, Inc. Office of Hearing Offices, Order Accepting Offer of Settlement (2002) (same).

state—actor). Although it is registered with the SEC as a self-regulatory organization pursuant to 15 U.S.C. § 78o-3(a), it was not created by statute. *Id.* Neither its directors nor its executives are governmental officials or appointees. *Id.* It receives no funding from any government, federal or state. *Id.* It has the power to govern the conduct of its members by virtue of the contractual relationship between it and its members. *Klitzman v. Bache Halsey Stuart Shields Inc.*, 499 F. Supp. 255, n.1 (S.D.N.Y. 1980). As such, neither NASD Rules nor Notices are binding on parties that are not NASD members.

As defined by this Court, judicial deference is due to a governmental agency where there is an express congressional authorization to engage in rulemaking or adjudication process that produces a rule or regulation. *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984). This is known as *Chevron* deference. This Court has also extended a lower standard of deference to a governmental agency's interpretations of its own rules. *United States v. Mead Corp.*, 533 U.S. 218 (2001). This is referred to as *Skidmore* deference. However, this Court has specifically found that interpretations contained in opinion letters, and particularly those that were not arrived at after a formal adjudication or notice-and-comment rulemaking process, do not deserve judicial deference. *Christensen v. Harris County*, 529 U.S. 576, 587 (2000). No court, however, has extended any level of judicial deference to non-mandatory suggestions of a private corporation, such as the NASD.

Petitioners' assertion that an NASD Rule deserves judicial deference is nothing more than an academic argument. In this case, the idea that an NASD Notice to Members, which has no effect on non-members, should carry the force of law is meritless, and does not deserve

this Court's attention. As such, Petitioners have failed to raise an important question of federal law that this Court should address.

II. THE DECISION OF THE SECOND CIRCUIT DID NOT CONTRAVENE SUPREME COURT PRECEDENT

A. The Second Circuit Court Of Appeals Did Not Contravene Supreme Court Precedent When It Did Not Give Judicial Deference To A Joint SEC/NASD Report

In a last ditch effort to revive their losing cause, Petitioners implored the Second Circuit to consider a joint report issued by SEC staff and the NASD entitled "Joint SEC/NASD Report on Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Product" ("Report"). *See* Office of Compliance Inspection and Examinations, United States Securities and Exchange Commission/NASD "*Joint SEC/NASD Report on Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Product*" (available at *http://www.sec.gov/news/studies/secnasdvip.pdf*). Petitioners argue that by failing to give the Report judicial deference, the Second Circuit contravened this Court's precedent. (Pet. at 26-27.) However, Petitioners' argument is unavailing for three reasons. First, the Report was not issued until June 9, 2004—almost four years after the class period and some three weeks after the Second Circuit's decision.[4] Second, a report that explicitly does not

[4] On May 14, 2004, the Second Circuit issued its unpublished opinion. On May 28, 2004, Petitioners filed a Petition for Rehearing and Petition for Rehearing *En Banc*. Subsequently, on July 15, 2004, Petitioners filed a letter with the Clerk of Court for the Second Circuit asking the panel take into consideration the Report in question. The Petition for Rehearing was denied on July 30, 2004. Therefore,

represent the views of the SEC is not entitled to judicial deference. And third, contrary to Petitioners' contention, the Report does not support their position.

American Skandia does not dispute the fact that rules promulgated by the SEC pursuant to its rulemaking authority carry with it the force of law, *i.e.*, *Chevron* deference. Rule 10b-5, which is promulgated under 15 U.S.C. § 78w(a), is a prime example of such a rule deserving judicial deference. However, as this Court has clearly held, interpretations, such as opinion letters, "which are not the result of a formal adjudication or notice-and-comment process," lack the force of law, and therefore are not necessarily accorded judicial deference. *Christensen*, 529 U.S. at 587; *see also Alaska Dep't of Envtl. Conservation v. Envtl. Prot. Agency*, 540 U.S. 461, 487 (2004) (holding that an agency's interpretation contained in an internal guidance manual does not deserve judicial deference); *Clackamas Gastroenterology Assocs., P.C. v. Wells*, 538 U.S. 440, 449 n.9 (2003) (holding that the EEOC's compliance manuals are not controlling); *Perez-Gonzales v. Ashcroft*, 379 F.3d 783, 793-96 (9th Cir. 2004) (finding that agency interpretation contained in a guidance memorandum that conflicted with immigration statutes did not deserve deference); *Air Brake Sys., Inc. v. Mineta*, 357 F.3d 632, 642-43 (6th Cir. 2004) (finding that the opinion letters of the chief counsel of the NHTSA are too informal to merit judicial deference); *Echeverria v. Chicago Title & Trust Co.*, 256 F.3d 623, 630 (7th Cir. 2001) (holding that judicial deference is not due to "unofficial interpretations which the agency itself does not view as bind-

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it was impossible for the Second Circuit panel that originally decided the case to have disregarded a report that did not exist. Moreover, as discussed *infra*, the Second Circuit in deciding a Petition for Rehearing was not obligated to rely on a report which does not represent the views of the SEC.

ing"); *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 163 (2d Cir. 2000) (holding that, unlike an SEC rule promulgated pursuant to its rulemaking authority, an SEC Staff Accounting Bulletin, "does not carry with it the force of law").

The Report specifically states that "[t]his report represents the findings of the Staff of the Commission and NASD, and *not the Commission itself*." Report at 3 n.1 (emphasis added). There is no basis to argue that a report by the staff, not adopted by the SEC, carries with it the same force of law as, for example, Rule 10b-5. In the words of this Court, it is a summary of findings, "not one arrived at after, for example a formal adjudication or notice-and-comment rulemaking. Interpretations such as those in opinion letters, like interpretations contained in policy statements, agency manuals, and enforcement guidelines, all of which lack the force of law—do not warrant *Chevron*-style deference." *Christensen*, 529 U.S. at 587 (internal citation omitted). As such, this Report does not merit judicial deference.

Moreover, Petitioners mischaracterize the content and import of the Report. This Report does not mandate that issuers of variable annuities prospectuses include any specific language within their prospectus. The Report "is not a comprehensive roadmap for compliance and supervision with respect to the sale of variable insurance products, but rather points out examples of common problems that may be encountered, and some measures that firms are using to ensure better compliance." Report at 3. The section Petitioners quote from is entitled "Disclosure" and states:

> With regards to sales of annuities in tax-qualified plans, the NASD states that when a *registered representative* recommends the purchase of a variable annuity for any tax-qualified retire-

> ment account (*e.g.*, 401(k) plan, IRA), the *registered representative* should disclose to the customer that the tax-deferred accrual feature is provided by the tax-qualified retirement plan and that the tax-deferred accrual feature of the variable annuity is unnecessary. Report at 18 (emphasis added).

Notwithstanding Petitioners' implication to the contrary, the Report does not state that an issuer of a variable annuities prospectus is mandated to include any language within its prospectus. The Report simply states that registered representatives *should*—not must—inform their customers that it is unnecessary to purchase a variable annuity for its tax-deferred feature for a tax-qualified retirement plan. This is a far cry from mandating the issuer of the prospectus to set forth this language in a prospectus that goes to all potential investors irrespective of their individual investment concerns.[5]

Petitioners' argument that this Report deserves judicial deference is not in accord with Supreme Court precedent, and is not supported by the Report itself. As such, Petitioners' claim that the Second Circuit's opinion contravenes this Court's precedent is meritless.

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[5] Further detracting from Petitioners' argument is the fact that the NASD is in the process of proposing a new rule regarding variable annuity sales. *See* April 26, 2004 NASD News Release "NASD Proposes Specific Requirements for Deferred Variable Annuity Sales, Concern Over Suitability, Disclosure, Supervision Cited" (available at *http://www.nasd.com/stellent/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_002835&ssSourceNodeId=553*). This release highlights the key requirements of the proposed rule. Most tellingly, there is absolutely no mention of any duty imposed on issuers of variable annuities prospectuses. The proposed rule focuses exclusively on registered representatives.

B. The Second Circuit Court of Appeals Did Not Contravene Supreme Court Precedent When It Dismissed the Complaint

As previously noted, both Judge Pollack and a unanimous panel of the Second Circuit found that the American Skandia prospectuses did not contain any material omissions. Petitioners contend that the Second Circuit's decision contravened this Court's precedent by determining materiality as a matter of law, as opposed to allowing the issue to go to the trier of fact. (Pet. at 27.) However, as this Court has recognized time and again, materiality can be determined as a matter of law if the alleged omission is obviously unimportant in light of the disclosures made. Moreover, even if the factual determination of the Second Circuit was incorrect, this unpublished decision is not enough to merit this Court's review.

It is well established by this Court that an "omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding" how to act. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). Stated another way: "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *Id.*

It is equally well-settled that "only if the established omissions are 'so obviously important to an investor, that reasonable minds cannot differ on the question of materiality' is the ultimate issue of materiality appropriately resolved 'as a matter of law' . . . ." *Id.* at 450.

After carefully reviewing the prospectuses, Judge Pollack aptly concluded:

> Nor do the allegedly omitted facts significantly alter the total mix of information made available. The Prospectuses clearly state that *both variable annuities and tax qualified retirement plans are tax deferrable*. That is enough to alert all reasonable investors to the fact that it is unnecessary, if solely for tax reasons, to use a variable annuity to fund a tax-deferred retirement account. *See In re NBTY, Inc., Sec. Litig.*, 224 F. Supp.2d 482, 495 (E.D.N.Y. 2002); *In re Ultimate Corp. Sec. Litig.*, No. 85 CIV. 5944 (CSH), 1989 WL 79372, at *5 (S.D.N.Y. July 11, 1989) ("Liability does not arise from the failure to disclose that which should be obvious to the average investor."). The other benefits of the variable annuities are also clearly set forth, as well as the fee structure for purchase of the annuity.
>
> The disclosures in the Prospectuses, taken in context, conclusively disprove the materiality of the alleged omissions and are thus fatal to the Plaintiffs' claims. (Pet. App. B at 10a-11a. (emphasis in original).)

The Second Circuit conducted a *de novo* review of the record and the prospectuses at issue, and likewise concluded that the American Skandia prospectuses contained no material omission:

> Nor did the failure to include the warning sought by plaintiffs constitute a material omission. An omission is material if there is a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available." *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988); *accord Ganino v. Citizens Utils. Co.*, 228 F.3d 161-62.

> Here the prospectus clearly states that the investment gains on annuities are not taxable "until an amount is received (a 'distribution')," Prospectus at 39, and that contributions to qualified retirement plans are "not taxable until distributions are made," Prospectus at 42. From this information, the reasonable investor would know that, since taxes on qualified retirement plans are not assessed until a distribution is made, funding a replacement fund with deferred annuities would provide no additional tax advantage. Adding a warning stating that the tax-deferred feature of a deferred annuity is "unnecessary" when the annuity is to fund a qualified retirement plan investments thus would not have "significantly altered the total mix of information" in the prospectus. (Pet. App. A at 5a-6a.)

Both Judge Pollack and the Second Circuit independently reviewed the prospectuses with painstaking care and correctly decided that the alleged omission was not material as a matter of law. These factual determinations do not contravene this Court's precedents.

Even if, *arguendo*, the Second Circuit did erroneously decide this case, it is still insufficient to warrant review by this Court. The Second Circuit's unanimous decision was an unpublished summary order. Pursuant to Second Circuit Local Rule 23, unpublished opinions cannot be cited as precedential authority to any court, including to the Second Circuit. *See* United State Court of Appeals for the Second Circuit, Local Rule 23 (available at http://www.ca2.uscourts.gov/). In other words, the decision of the Second Circuit has no binding effect on any court. Thus, if confronted with a factually similar case, the Second Circuit could reach a different decision.

The Second Circuit made a complex factual determination based on the specific facts of this case; it did not conflict with this Court's jurisprudence. Petitioners' argument to the contrary is unavailing.

CONCLUSION

For the reasons set forth above, the Petition for a Writ of Certiorari should be denied.

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